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The Early Stage Term Sheet

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After making the decision to invest in an early stage company, an investor must consider both the type and value of the securities which will embody the deal. There are several types of securities, which may be used in these types of investments, including debt, equity or a hybrid form of security.[1]

Common forms of debt securities include subordinated debentures with warrants and convertible subordinated debentures. An angel round of financing can consist of a bridge loan in the form of convertible debentures with warrants where the debentures convert into Series A Preferred Stock upon the first venture capital round (i.e., the Series A round). The warrants provide an extra upside to the angel investor for providing funds early in the life of the enterprise. The most basic form of equity is common stock. However, common stock does not provide an investor with any advantages over the entrepreneurs and other stockholders of the company. Senior equity securities such as convertible preferred stock are the most popular form of investment in early stage venture capital. The company (and probably the company's lender) tends to prefer issuing equity to debt. Preferred stock generally contains certain rights and protections, which provide the investor with a certain amount of control and downside protection.[2]

The typical term sheet contains a host of provisions designed—in varying degrees—to protect the value of an investor's capital. These terms define the rights of the investor as a holder of preferred stock. Key among these provisions are those that secure the ownership position of the investor, provide the investor with the right to monitor and control company decisions, and facilitate exit from the investment. While many good references exist which summarize and describe the terms relating to preferred stock (see Appendix), the purpose of this note is to focus on a few key terms (namely, anti-dilution, liquidation preference, dividends, redemption, and control rights), and to discuss the ways in which these terms may be made more investor friendly or entrepreneur friendly, respectively.

[1] It is important to note that each type of security has different economic, tax and accounting characteristics for both the investor and the company.
[2] These special rights also help justify a higher price for the preferred stock as compared to the price paid by the entrepreneurs and employees for the common stock (thereby avoiding expensive tax liabilities for the entrepreneurs and employees).

This note was prepared by April Triantis, Associate Professor, University of Virginia Law School and Susan Chaplinsky, Professor of Business Administration with the assistance of Matthew Young (JD/MBA '04). Copyright © 2003 by the University of Virginia Darden School Foundation, Charlottesville, VA. All rights reserved. *To order copies, send an e-mail to* sales@dardenpublishing.com. *No part of this publication may be reproduced, stored in a retrieval system, used in a spreadsheet, or transmitted in any form or by any means—electronic, mechanical, photocopying, recording, or otherwise—without the permission of the Darden School Foundation.*

The terms discussed in this note are widely regarded by practitioners to be those that have the greatest ability to affect the respective economic returns for the parties involved in an early stage investment. While in any given transaction, a particular issue could arise that would require terms other than those covered here, most early stage investments will require an understanding of these terms as they cover rights relating to the preservation of capital and the size of the potential returns. These rights will be of concern in all early stage deals. At the end of the discussion of each term, a chart is provided which highlights the various ways in which these terms can be structured. The examples, while not meant to be exhaustive, offer a perspective on the various ways a term might be worded in order to confer different rights between the parties.

Anti-Dilution (non-price based)

Preferred stock typically is issued with what is often referred to as structural (non-price based) anti-dilution protection, which protects against the effects of stock dividends, stock splits, reverse splits, and other recapitalizations. This is the most basic form of anti-dilution protection. The typical tool for accomplishing this type of structural anti-dilution is an adjustment to the *conversion price* (which is initially set to be the same as the original purchase price). Depending on the triggering event, the conversion price is adjusted to ensure that the preferred shareholder will receive a number of common shares upon conversion that maintains the shareholder's original percentage of ownership. For example:

- Preferred shares are originally sold for $2.00 per share.
- The conversion price is initially set at $2.00 per share (ensuring a one-to-one conversion into common).
- The company decides to have a 4 to 1 stock split of its outstanding common shares.
- The conversion price is reduced to $0.50 (i.e., 1/4th of its previous amount).
- Each preferred share would now convert at the ratio of $2.00/$0.50 or four common shares for each preferred share.

Another form of non-price based anti-dilution protection is a *right of first refusal* (also called a *preemptive right* or a *right to participate*). These provisions allow the preferred stockholder to purchase a pro rata share of future issuances of stock by the company (or sales of stock by the founders), thereby permitting an investor to maintain his or her percentage ownership. These provisions are particularly important in protecting an investor's ownership percentage in an "up round" of financing. On its face a preemptive right may appear to be an innocuous right since the company typically is concerned more with the funds raised from the sale of securities than with the identity of the buyer of those securities. However, in some cases, a company may want to sell a certain percentage of the company to a strategic buyer and not be forced to offer those shares to the current investors. As such, it is common for these rights to be accompanied by an exception for the sale of stock to strategic partners, consultants, employees, or directors. Another condition often placed upon these rights is that an investor must hold a minimum percentage of preferred stock in order to exercise such right. Furthermore, in

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exchange for granting such rights, an entrepreneur may request that the right be reciprocal (i.e., that the company or entrepreneur has a right of first refusal on sales of the preferred stock by the investor).

Anti-Dilution (price based)

The valuation of early stage companies is highly uncertain. As a result, an investor could be investing in a company whose value adjusts downward before the company stabilizes and resumes positive growth in value. For this reason, investors often seek price protection—that is, protection from the dilutive effects of a later round of financing that is priced below the price at which they bought into the company. There are two common forms of price protection: *full-ratchet anti-dilution protection* and *weighted average anti-dilution protection*.

Full-Ratchet Anti-Dilution Protection

Full-ratchet anti-dilution lowers the conversion price to the price at which any new stock is sold. This type of protection is generally considered to be a severe form of anti-dilution protection because it forces the common shareholders to absorb most of the dilution. For example, assume that the Series A investor bought preferred shares at $1.00 per share and, later, Series B investors bought shares at $0.50 per share, then the conversion price of the preferred shares owned by Series A investors would be adjusted downward to $0.50. In effect, the adjustment in the conversion price allows the Series A investor to "pay" the same for its shares as the Series B investor.[3] Importantly, this pricing adjustment occurs regardless of how many shares are issued (or the amount of money raised) in the Series B round. Thus, a company seeking to issue a small number of shares in order to raise the needed capital will be forced to adjust the share ownership of all preferred shareholders.

The impact of full-ratchet protection on the common shareholder is illustrated in Table 1 below. The example makes the following assumptions:

- Common shareholders own 7.5 million shares.
- Series A Preferred shareholders buy 2.5 million shares at $1.00 a share for $2.5 million. Following the Series A round the firm has a $7.5 million pre-money valuation and a $10 million post money valuation (i.e., $10 million = $2.5 million ÷ 25% ownership stake).
- Series B Preferred shareholders later buy 2 million shares at $0.50 a share for $1 million. Following the Series B round, a *down round*, the pre-money valuation of the firm is $5 million and the post-money value is $6 million (i.e., $6 million = $1 million ÷ 16.67% ownership stake).

[3] Note that no capital is returned to the investor as a result of a full ratchet adjustment. Rather, simply issuing more shares to the Series A investor upon conversion effects this adjustment.

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Table 1				
	Conversion Price of Preferred Shares	**Shares Issued (000's)**	**Common Shares After Conversion**	**Percent of Company Owned**
Capitalization − No Dilution Protection				
First Round				
Common Shares		7,500	7,500	75.00%
Series A Preferred Shares		2,500	2,500	25.00%
Series A Conversion Price	*$ 1.00*			
Second Round				
Common Shares		7,500	7,500	62.50%
Series A Preferred Shares	*$ 1.00*	2,500	2,500	20.83%
Series B Preferred Shares	*$ 0.50*	2,000	2,000	16.67%
Second Round Capitalization – Full-Ratchet Dilution Protection				
Common Shares		7,500	7,500	51.72%
Series A Preferred Shares	*$ 0.50*	2,500	5,000	34.48%
Series B Preferred Shares	*$ 0.50*	2,000	2,000	13.79%

Note that following completion of the Series B Round financing, the 2,500 shares of common the Series A Preferred Stock originally held, would convert to be 5,000 shares under full-ratchet dilution. Series A investors' percentage ownership increases primarily at the expense of the firm's common shareholders.

Weighted Average Anti-Dilution Protection

Another frequently encountered form of dilution protection in early stage deals is *weighted average anti-dilution*. Weighted average anti-dilution (WAAD) is generally thought to be more favorable to the entrepreneur who typically holds common shares. As shown in the formula below, WAAD adjusts the conversion price of the Series A investor by considering both the size and price of the dilutive round of financing. Stated another way, the formula allows the conversion price to be adjusted according to the relative percentage of ownership that is being sold at the lower price. Therefore, as can be seen in Table 2, the dilutive impact on common shareholders is greatly reduced.

The formula has several forms and will sometimes include for purposes of dilution protection the number of stock options outstanding. When options are taken into account the protection is said to be "broad based" and when they are excluded it is said to be "narrow based." An example of a weighted average formula is as follows:

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NCP = New Conversion Price
OCP = Old Conversion Price
OB = Outstanding Shares before Current Issuance
AMT = Amount Invested in Current Round
SI = Shares Issued in Current Round

NCP = OCP x (OB + (AMT/OCP))/(OB +SI)

Applying this formula, the new conversion price in our hypothetical investment above equals:

NCP = $1.00 per share x (10M + ($1M/$1.00))/ (10M + 2M)
NCP = $0.917

The new conversion price of $0.917 implies that preferred shareholders who bought in at $1.00 will be able to convert their shares of preferred into 1.09 common shares (as compared to full ratchet protection, which implied a conversion price of $0.50, or 2 shares of common per preferred upon conversion). The effects of weighted average protection on the company's capitalization following the Series B round is shown in Table 2.

Table 2

Second Round Capitalization – Weighted Average Dilution Protection

	Conversion Price of Preferred Shares	Shares Issued (000's)	Common Shares After Conversion	Percent of Company Owned
Common Shares		7,500	7,500	61.34%
Series A Preferred Shares	*$0.917*	2,500	2,726	22.30%
Series B Preferred Shares	*$0.50*	2,000	2,000	16.36%

Price-based anti-dilution protection is sometimes subject to a "pay-to-play" provision, which makes the application of certain protective provisions contingent on the preferred stockholder purchasing at least its pro rata share in a new round.[4]

The table below summarizes the manner in which the anti-dilution terms can be negotiated to afford greater benefits to the parties involved. While not meant to be

[4] Note that pay-to-play provisions may also affect other rights, such that a failure to "play" in the next round may result in a loss of several protections (thereby creating what is often referred to as "shadow preferred"). A more severe version of pay-to-play forces conversion of the preferred stock into common stock upon a failure to "play" in the next round.

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exhaustive, the examples offer a perspective on how the same term within the term sheet can be worded to shape the relative rights of each party.

Price-Based Anti-Dilution Protection Terms		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Full ratchet	Weighted average Pay-to-play provision	None (structural anti-dilution protection only)

Non Price-Based Anti-Dilution Protection Terms		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Unqualified right of first refusal on company issue or shareholder sales Right terminates on qualified public offering ("QPO")[5]	Must hold minimum number of preferred shares (e.g., 15%) in order to exercise right of first refusal on company issues Right terminates on QPO	Must hold minimum number of preferred shares (e.g., 25%) in order to exercise right of first refusal on company issues Right terminates on initial public offering ("IPO")

Liquidation Preference

The basic idea behind the *liquidation preference* is that the holder of preferred shares, upon a liquidation, dissolution, or sale of the company, must be paid some stipulated amount prior to the distribution of any proceeds to the common shareholders. Liquidation is usually defined to include a consolidation or merger in which the company's shareholders will hold less than a majority of the surviving entity's shares or a sale of substantially all of the company's assets. A conventional liquidation preference is considered a "single-dip" preference. With a conventional liquidation preference, the preferred stockholder must *choose* between receiving the liquidation preference or converting to common stock in order to share pro rata in the total proceeds. For example, consider a Series A investment of preferred shares, representing 50% of the company, sold to investors for a total of $3 million. The preferred shares have a liquidation preference equal to the original price paid for those shares, or $3 million. Sometime thereafter the company is liquidated for $5 million. Having a choice between receiving $3 million or 50% of $5 million, the Series A investors choose the former and the common shareholders receive the remaining $2 million.

One can see from this example that the preferred shareholders receive value-preserving protection through their preference. If the value upon liquidation were

[5] A *qualified public offering* (or "QPO") is generally defined as an initial public offering which (1) is firmly underwritten, (2) must raise a specific amount of money and (3) will be at a certain minimum price (e.g., three times the conversion price of the preferred stock).

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higher—say $10 million—then the preferred shareholders would have no reason to exercise their liquidation preference and would instead convert their preferred shares to common share and participate *pro rata* in the liquidation proceeds and receive $5 million.

Participating Preferred ("Double Dip")

A liquidation preference can also be structured such that the preferred shareholder will not only receive the liquidation preference, but will also participate with the common stock on an "as-if -converted" basis. This is known as *participating preferred* or a "*double-dip*" preference. Often the participation feature of a preferred stock will contain a cap such that the preferred stock will stop participating once it has received a total amount equal to some multiple of the original purchase price. [6]

Consider the same Series A investment above but in this case investors hold a participating rather than a conventional liquidation preference when the company is liquidated for $5 million. In this case, investors will receive $3 million *and* 50% of $2 million, for a total of $4 million compared to $3 million under a conventional preference. Assuming the investment and liquidation occurred one year apart, the participation feature raises investors' realized return to 33% ($4 million/$3million -1) versus 0% under a conventional liquidation preference ($3 million/$3million -1). From an investor's point of view, such a provision enhances the prospects that the targeted rates of return will be achieved. The higher the pre-money valuation an entrepreneur demands or the later the stage an investor enters to provide funds, the more likely investors are to seek a participation feature.

Liquidation Preferences		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Participating (original purchase price plus dividends, then share with common on as-converted basis)	Capped participating (e.g., once equal 3x original purchase price)	Simple preference (original purchase price plus dividends)

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Dividends

Working hand and hand with the liquidation preference is the right of the preferred shareholder to an annual or quarterly dividend to be paid in preference to the holders of any other class of stock. Dividend rates between 6-8% are commonly observed, and this rate can be adjusted upwards or downwards based on the relative bargaining power of the parties. Such dividends are generally payable only at the discretion of the Board of Directors and can be paid either in cash or stock. Because it

[6] Note then that the "double dip" participation feature does not apply when the exit from the investment is via an initial public offering or otherwise defined QPO.

would be uncommon for the Board of an early stage company to actually declare and pay a dividend, some deals provide for a mandatory dividend that accumulates regardless of the Board's action (a *cumulative dividend*). Such a dividend is an obligation of the company irrespective of the company's earnings or ability to pay. Cumulative dividends are usually paid (a) at the discretion of the Board, (b) upon redemption, or (c) upon liquidation.

The principal reason for a cumulative dividend right is to raise, over time, the value of the preferred shareholder's preference upon liquidation (given that the liquidation preference is generally set at the original purchase price plus any accrued or unpaid dividends). The practical effect of adding cumulative dividends to the liquidation preference is to lock in a minimum rate of return for the investor in the event of a sale or liquidation of the company.

A cumulative dividend acting in concert with a conventional liquidation preference works as follows:

- Initially, Series A Preferred Shares, representing 50% of the company, are sold to investors for a total of $2 million.
- The Series A Preferred has a right to an 8% annual cumulative dividend payable in cash (a) if, when declared by the board of directors, (b) upon redemption or (c) upon liquidation of the company.
- The preferred shares have a liquidation preference equal to the original price paid for those shares <u>plus</u> any accrued and unpaid dividends.
- Three years later, the company is liquidated for $3 million.
- Series A Preferred shareholders exercise their liquidation preference and receive $2 million (original purchase price) plus $480,000 (3 years of dividend payments) for a total payout of $2.48 million.
- Preferred shareholders receive a 7.43% Internal Rate of Return (IRR) on their original investment.
- Common shareholders receive $520,000.

Had investors instead held a participating liquidation preference along with a cumulative dividend, their payout would increase to $2.74 million ($2 million (original purchase price) plus $480,000 (3 years of dividend payments) plus 50% of the remaining $520,000 to common shareholders). In this case, the preferred shareholders' IRR improves modestly to 11.06%.

The investor and the entrepreneur will have different views as to the wisdom of offering a cumulative dividend and an increasing liquidation preference. Early stage investors can argue that their funds are more valuable to the venture (i.e., the funds come at a critical time, they represent a value added investment, etc.) and therefore they should receive some sort of minimum guaranteed return. However, from the entrepreneur's perspective, these provisions can create a situation where the interests of the common and preferred shareholders will not always be aligned. For example, a situation could arise in which the preferred shareholders push for a sale or liquidation of the company so that

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they can exit an investment in which they have lost faith. In such a situation the preferred shareholders may push for a deal that would generate a slight positive return for them (due to the cumulative dividend preference) while the common shareholder would bear any and all loss.

Dividend Terms		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
15% Cumulative	8% Non-cumulative	No dividends (completely at board discretion)

Redemption

A fairly contentious term that is sometimes part of early-stage investments is the right of the investor to force the company to redeem (buy-back) the investor's stake at a specified time in the future.[7] The principal reason for the inclusion of this term is to provide investors with a known liquidity event in case the investment begins to perform poorly.

Entrepreneurs often feel threatened by this term because it appears to cross the incentives of the preferred and common shareholders. An early stage company still trying to stabilize its operations could find itself approaching a redemption deadline without the requisite cash to both redeem the preferred issuance and continue operations. The company's board could at that time find itself contemplating—in an effort to prevent redemption and the prospect of certain bankruptcy—a liquidity event that would not be in the best interests of the company and the common shareholders.[8] Furthermore, redemption rights may serve to block future financings, as potential investors might fear that their investment would simply be used to pay for such redemption.

Notwithstanding the above, investors are clearly advantaged if they are able to negotiate a right of redemption.[9] When a redemption right is granted, the parameters of the right are usually constrained in some way, such as making the right exercisable only after some period of time (e.g., six or seven years) or conditioning the redemption upon the approval of a percentage (e.g., 80%) of the preferred stockholders. A further condition may require that the redemption payment be spread over two or three years in order to soften the negative impact of redemption on the company's cash flow.

[7] Note that the entrepreneur may, in conjunction with granting redemption rights to an investor, request similar rights for the company (such that the company has the right on a specific date to force the investor to sell back their stock; in effect, a call right).
[8] Another reason entrepreneurs dislike this provision is that banks tend to treat preferred stock with redemption rights as debt (which can affect lending relationships).
[9] It is important to note that while the right may lose its practical advantage if the company has no money to redeem, it may provide an important bargaining chip in a future round (i.e., a "down round") of financing.

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The price at which the stock will be redeemed is usually either the fair market value of the stock (as determined by a mutually agreed-upon appraiser) or the original price of the stock (or some multiple thereof) plus unpaid dividends.

Redemption		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Majority vote of preferred required to force redemption	2/3 vote	No provision
1/3 redeemed at year 3 1/3 redeemed at year 4 1/3 redeemed at year 5	1/3 at year 5 1/3 at year 6 1/3 at year 7	
Price = 3x original purchase price plus dividends	Price = original purchase price plus dividends	

Control Rights

There are two main ways in which an investor may exercise overt control over company decisions. The most obvious way is for the preferred stockholders to have a right to designate members of the board of directors. The board of directors manages the company's business affairs and it appoints officers to carry out daily operations. Directors are elected by shareholders; generally by a voting scheme of one-share, one-vote. However, a voting agreement can provide that certain shareholders elect a designated number of directors. Therefore, board control does not necessarily follow ownership percentages. Investors can negotiate a variety of types of board involvement ranging from outright control, a seat on the board, or simply observation rights. Observation rights permit an investor representative to attend board meetings but do not carry any voting rights. Furthermore, investor rights can be structured such that as the company progresses and meets certain milestones, the number of investor representatives on the board may decrease. Conversely, the rights can be structured such that if the company fails to meet such milestones or otherwise breaches any of its covenants with regard to the preferred stock, the preferred shareholders may acquire the right to elect a majority of the board. However, it is worthwhile considering the fact that directors owe fiduciary duties to the company and its shareholders and these duties can create substantial legal liabilities. Investors may prefer to exercise control in other ways, such as through voting controls (generally referred to as “protective provisions”) over certain actions.

Protective Provisions establish the requirement for a vote by the holders of the preferred stock before the company can take certain actions. The approval threshold for such a vote may range from a simple majority (preferred by the entrepreneurs in order to facilitate certain actions, such as future financings) to a supermajority (preferred by an investor in order to retain a high level of control over such actions). Often these voting controls are subject to a percentage “floor.” In other words, if the number of outstanding

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shares of preferred stock drops below a certain percentage (e.g., 25%), these voting controls would be extinguished. Actions that are subject to a vote generally include any changes to rights specifically designed to protect an investor's interest (e.g., those relating to dividends, liquidation, conversion, redemption, dilution, voting, the issuance of additional shares, and the structure of the board of directors). Investors will also want some control over any action in which they risk a loss of control, such as certain asset sales, mergers and other types of consolidations or major changes in ownership.

Board Representation		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
Elect majority of board	Elect a representative onto board	Elect representative to act as board observer (no voting rights)

Protective Provisions (Voting Controls)		
Investor-Favorable	Middle-of-the-Road	Entrepreneur-Favorable
80% approval of preferred necessary for certain actions (exhaustive list)	2/3 approval of preferred necessary for certain actions (moderate list)	50% approval of preferred necessary for certain actions (short list)

Conclusions

This note has outlined the impact of key terms of an early stage term sheet to the parties involved in the deal, the value of the investment, and the available alternatives to each term. That said, whether the terms of the preferred stock for a particular deal turn out to be investor friendly or entrepreneur friendly depends in large part on market conditions and the strength of the bargaining powers between the respective parties.[10] Factors which can influence the relative bargaining power between the two parties include how critically the funds are needed, how well the company is doing, how many other potential investors are interested, the number of similar investments available, and a particular investor's risk and return goals. It is important to use bargaining power wisely and to focus on those terms which have the greatest capacity to make a material difference in the returns and outcomes of the respective parties. The old adage about choosing one's battle carefully is a good guide for early stage investment.

[10] For an excellent discussion on the current state of venture capital terms, see Barry Kramer and Mike Patrick, *Recent Developments in Venture Capital Terms*, National Venture Capital Association Journal (Summer 2003).

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Appendix

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