There are three goals for this lesson. First, to provide students with a general overview of the process and the issues involved in seeking VC financing. Second, to highlight the major conflicts entrepreneurs and VCs will encounter in negotiating a financing round. A set of questions addresses the students’ understanding of these issues. Third, to the extent the instructor wishes, to require students to engage in a close reading of documents, students can be asked to review the term sheet at the end of the chapter against the Model Term Sheet produced by the National Venture Capital Association (“NVCA”). Assigning this task (Question 4 at the end of this document) expands the work considerably, and turns it into a major assignment for the law students involved. It would be a good lesson in the case with which documents should be reviewed. For the teacher, the work is done in this chapter.

THE OVERVIEW
What follows is a basic outline for a lecture, should you choose to employ it.

ORGANIZATIONAL STAGE PLANNING
Financial needs should be estimated at the start.

- Capital raising should be timed to go with achievement of milestones, when valuations are at their highest, and when you can demonstrate that you can deliver on the promises of the business plan.
- Raising funds prematurely gets you a lower stock valuation, and thus greater dilution for founders.

Authorize sufficient common stock to cover:

- Founders’ shares at whatever amount they can afford or need to get started.
- Angel financing round shares
- Two or three rounds of VC financing when warrants or convertibles are exercised.
- 10 - 20% for employee stock options.

Authorize sufficient “blank check preferred to cover VC rounds.

- “Blank check” preferred shares are authorized in Articles of Incorporation, with a grant of authority in the board to fill in the details at the time a financing is negotiated.
  
  M.B.C.A. §6.02; Del. GCL §151(a).

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ANGEL FINANCING

Friends & Family - original round in common stock.

The more you finance this way, the further along you get in reaching milestones, so the first round of outside funding will be at higher valuations.

Tax warning: If shares are sold to founders at one price while friends and family are paying a higher price, the founders are taxable on compensation income at the difference between what they paid and what outsiders are paying.

Angel Investors who provide seed capital on individual basis - typically common stock.

Stock options for key employees (plan on reserving up to 20% of long-term equity)

Common stock is easy because it involves no negotiation of terms.

Key employee stock options are another matter – option plans are custom-tailored documents, in some cases to qualify for tax-free treatment of issuance of options.

INCUBATORS

Universities, some local & state governments & others that provide office space, technical advice & modest amounts of cash.

VENTURE CAPITAL FUNDS

The Professionals, making larger investments at second or third round.

CORPORATE JOINT VENTURES

Large companies that see synergies with their business.

Willing to pay development costs in exchange for ownership, with royalties to the originating company.

May pay cash as milestones are met.

May invest some cash in stock.

EMPLOYEE STOCK AND STOCK OPTIONS

In lieu of cash, stock options are used by start-ups to attract & hold essential employees.

INCENTIVE STOCK OPTIONS

Benefits:
No income tax at time of grant of options.
No income tax at time of exercise.
If the employee holds the stock for one year after exercise and two years after grant of the options, the employee will only be taxed at the time of sale, at the long-term capital gains rate.
If the employee disposes of the shares early, it’s taxed as compensation at ordinary income rates.
Ordinarily the company gets no tax deduction for issuance of the options or shares, but if the employee sells early, the company gets a deduction equal to the income realized by the employee.

Requirements:
Exercise price must = Fair Mkt. Value at time of grant.
Can only be granted to employees, not to non-employee directors or consultants.
Must be nontransferable, and not exercisable for longer than 10 years.
Must be granted pursuant to a written plan approved by shareholders within 12 months before or after adoption of the plan.
Employees can only get favorable tax treatment if they exercise while still employees or within 3 months of leaving.
$100,000 limit per year on value of stock which employee can exercise.

**Nonqualified Stock Options**

Benefits:
No tax at time of grant of options.
At exercise, the difference between exercise price & market value is treated & taxed as ordinary income.
Options can be granted to non-employee directors & consultants.
Typically options shouldn’t exceed 15-20% of outstanding shares after the first round of VC financing.

**Restricted Stock** may also be used to compensate employees.
Object is to provide a means to hold valued employees, by providing that employees’ restricted stock is forfeited (or sold to employer at cost) if the employee leaves before fully vested.
Restricted stock given solely in exchange for services is treated as earned income when
transferred.

If the employee makes an election under IRC §83(b) within 30 days of receipt, the employee only recognizes income to the extent of the difference between FMV and price employee paid.

This may not be so bad at the start-up stage, when stock values are very low.

The benefit here is that when the stock is sold, the employee gets capital gains treatment.

If there is no §83(b) election, the employee doesn’t recognize taxable income until the stock vests.

In this case income is the difference between the value on the date of vesting and the price paid.

PREPARING FOR LATER ROUNDS OF FINANCING

RECORD KEEPING

Lawyers generally have check lists they use when investigating a business - VCs will, too.

Being ready to respond to requests for documentation and information shows organization.

At an early stage, before systems are set up, it may be useful to place all important records in a box and deliver them to the lawyer for organization & filing.

CORPORATE ASPECTS

Keep articles of incorporation, bylaws, & corporate minutes in minute book - perhaps kept by counsel.

Keep permanent records on stock issuance in stock transfer ledger (use counsel)

Keep permanent originals of all stock option plans, all warrants issued in course of business.

Make sure originals are fully executed.

Some questions VCs and their lawyers will ask:

Will the company have enough shares of common stock to honor all conversion rights?
Do shareholders have preemptive rights unless denied in articles of incorporation?
Are there any restrictions on the transfer or voting of stock?
Is shareholder approval necessary to authorize new preferred stock?
Is the Company qualified to do business in all states where required?
If the Company is not qualified, are any of Seller's rights in those states subject to forfeiture or non-enforceability?
What penalties will be imposed in states where Seller has not been properly qualified?

Securities Laws Governing Issuer

Does the Company have any contingent liabilities for previous sales of securities under either state or federal law? (Review claims to exemptions for recent sales, which will include documentation).

Bylaws

Are there any restrictions on the transfer or voting of stock?

Minute Books

Are there any restrictions on the transfer or voting of stock?

Are there any powers of attorney outstanding with respect to voting securities? (Can shareholders vote to approve authorization of preferred, or does a creditor hold some voting power?)

Provide a summary description of the rights of each class of outstanding security approved by the board under any "blank preferred" authority, or of debt issues. Do existing classes or series of preferred have any veto power over new issues?

Are there outstanding warrants, options or conversion rights that must be honored, or can they be canceled or redeemed?

If preemptive rights ever existed, have they been honored? Are there records of waivers?

Was common stock validly issued, fully paid and non-assessable? (This may affect whether voting to elect directors was valid.)

Are there employment agreements that impose long-term obligations on issuer, or provide for severance payments on a change in control?

Are there officer or employee benefit plans that impose long-term obligations on the seller?

Bonus plans?

Profit-sharing agreements?

Retirement plans, and other fringe benefit agreements, such as life insurance, hospitalization, major medical?

Any contracts providing special retirement payments to former officers or employees?
Any contracts providing consulting payments?
Voting trust agreements that restrict transfer or voting of stock?

**Stock Books**
Outstanding shares
Number of shareholders
Were applicable taxes paid on original issue and transfer of shares?
Were transfers from estates, trusts or other fiduciaries legal?
Is there any record of pledges of outstanding shares?

**Other Documents**
All patent documentation:
   Lab & bench diaries of discovery
   Applications
   Letters patent
   Assignments
   Licenses
Employment agreements:
   Trade secret agreements with employees
   Assignment of inventions while employed
   Non-compete agreements, not to solicit company employees or customers after leaving.
Property:
   Title to Property
   Leases - how long do they run, at what price can they be renewed, and is the company in compliance with lease terms.

**TYPES OF FINANCING IN VC DEALS**
VC financing is expected to be in stages.
The ideal is to achieve higher valuations at each subsequent stage.
This requires achievement of milestones that add value.
(And good luck with stock markets.)
VC financing should be negotiated well in advance of need.
It may take 4 - 6 months to negotiate a deal. Only use investment banks, attorneys & accountants as intermediaries to locate VCs. There are few “finders” who add any real value. VCs typically will begin with their own standard form of term sheet.

**COMMON STOCK**
Almost never used directly, because it provides no priority over the founders & angels if things don’t go well. Gets diluted by new issues, unless preemptive rights are granted and buyer wants to keep spending. But all other instruments are convertible into it. In hot market, an attractive issuer may be able to insist that VCs take common, but this is rare.

**CONVERTIBLE DEBT**
Infrequently used in the dot.com bubble. Some writers believe use of debt will increase.
Advantages of debt to VCs:
If secured by company assets, the VCs have a priority in bankruptcy. Debt can be in default if company misses milestones, giving VCs greater leverage.
Since development stage cos. are burning cash, there is no expectation of current payment of interest. Notes will either be issued with no interest obligation at discount from face amount calculated to produce an acceptable return to the investors, Or will accrue interest, which will only be paid at the earlier of:
- Maturity of the notes;
- At the election of the holder to exercise its accompanying common stock warrants, in which case the notes shall be repaid in common stock;
- On default, which may be set as failure to meet milestones, which gives creditor considerable leverage over the company, and provides an exit opportunity;
- Upon completion of the current round of equity financing, in which case they convert into preferred.
Sometimes after several rounds of VC financing with convertible preferred, a company with a short-term cash shortage before product revenues begin might obtain debt financing from “Venture Lenders.”
- These lenders will demand collateral - a security interest in most of the assets of the business.
- A leading biotech lender, Symphony Capital, LLC, creates separate entities into which valuable assets are placed, with Symphony providing capital for development, with the borrower having the right to buy out Symphony’s shares when the project produces revenue.
COMMON STOCK WARRANTS
In debt financings, VCs will typically want either conversion rights for their notes or separate common stock warrants.

CONVERTIBLE PREFERRED STOCK
This is the dominant form of VC financing.

Dividends:
While the stock will provide for cumulative dividends, they are not expected to be declared and paid on a regular basis, because cash is expected to be burned during the development stage.
Generally these dividends just accrue, and at any conversion of the preferred, the accrued dividends “buy” additional shares of preferred, which convert into common on the same basis as the remainder of the preferred.
If different series of preferred are to be used at each stage, need to think about priorities among series.
  o Will this series have the same priority as all other series, or be senior to them?
  o Frequently priorities and relative rights are renegotiated among VCs as each new round occurs.

Liquidation Preferences:
Conventional Preferred gets its purchase price back plus accrued dividends.
VC Preferred often gets a much higher price, designed to give VCs the 40-50% return on capital they expect.
This may be a multiple of the purchase price plus accruals.
Or this may be accomplished by taking the remaining assets, after the Preferred’s fixed liquidation rights are paid, and sharing the residue between common and preferred as if the preferred had been converted. (“Participating Preferred”)

Conversion Rights:
Each share of preferred stock becomes convertible into shares of common stock.
Typically the preferred’s purchase price is based on the current valuation of the common, so it becomes convertible on a one-for-one basis.
Convertible at any time.

Automatic Conversion on specified events:
  • An Initial Public Offering
  Underwriters won’t take a company public that has an overhang of lots of dilutive conversion rights or options, so conversion is necessary.
  While conversion is automatic, the VCs will have approval power because the automatic conversion is often conditioned upon an IPO at a stated value that gets
the VCs a high rate of return, which they may choose to waive to permit the IPO to go ahead. This gives the VCs the marketable security they can use to exit the investment.

- A Sale of the Business, if the price is equal to the IPO price agreed on in advance. If the sale price is lower, the VCs may choose to approve the transaction and take their preferences on the preferred on liquidation.

**Anti-Destruction Protection:**

Holders of conversion rights get only what they contract for. If the Company into which their preferred converts disappears, so do their conversion rights.

Two forms of protection:

I. Veto power as a class on any merger unless it provides protection.
II. Formula protection, that allows them to receive whatever common receives, whenever they convert.

Sample:

“If any capital reorganization . . . or consolidation or merger of the Company with or into another corporation, or the sale of all or substantially all its assets to another corporation shall be effect in such a way that holders of Common Stock shall be entitled to receive stock, securities, cash or other property . . . then, as a condition of such . . . merger . . . lawful and adequate provision shall be made whereby the Holder shall have the right to acquire and receive, upon exercise of the Conversion Right, such shares of stock, securities, cash or other property issuable or payable . . . with respect to or in exchange for the exercise of this Conversion Right as the Conversion Ratio then in effect.”

**Anti-Dilution Protection:**

Courts provide no equitable protection - it’s all by contract. Designed to protect conversion rights’ value by assuring that if common stock is sold below the valuation set on it at the time of issuance of this preferred. Also provides protection from stock splits and stock dividends. Also protects company by providing for a reduction in shares on conversion if a recapitalization reduces the number of shares (reverse stock split).

**Exceptions** typically cover shares issued to employees under option plans or restricted stock plans, but with a specified limit. Also shares purchased on conversion of preferred or warrants connected to debt issued prior to this round.
There are at least two basic possible adjustments – all involve issuing more shares on conversion.

**Full Ratchet**

This means that if *any* shares are sold cheaply, then the effective purchase price at the conversion is the lowest price paid for any shares.

Thus, if one share is sold cheaply, which has little dilutive effect, the VC’s conversion rights are adjusted to allow conversion of all VC shares at the lower price.

**Weighted Average**

This formula adjusts downward, but it takes into account how many shares were sold at the cheaper price.

Thus a small issue at a cheap price will have little effect.

(Old Conversion Price) (No. outstanding Shs. + no. newly issued shs that could be bought at conversion price for the new consideration) / No. outstanding shs. + newly issued shs.

Example:

Assume VC has a “conversion price” of $1.00

If one new share is sold @ $.01, under **Full Ratchet**, VC gets 100 times as many shares on conversion.

If one new share is sold @ $0.1, under weighted average, VC gets trivial increase in shares upon conversion

Using example in outline, where conversion price is $1.00,

1,000,000 shares of common are outstanding

VC owns 200,000 shares of preferred.

**Weighted Average Formula:**

\[
\frac{1.00 (1,000,000 + .01)}{1,000,001} = 1.00 \times 0.999999
\]

At the new exercise price, 200,000 / $0.999999 = 200,000.2 shares

**Pay to Play Qualification:**

In order to get the lower conversion price, the VC has to participate in the “down round” by purchasing its pro rata share at the lower price.

**Voting Rights:**

Typically the preferred votes on the same basis as the common.

With separate voting rights as a class on critical issues (a veto power):

- Mergers & other sales of the business;
- Alteration of the rights of the series or class of preferred;
- Issuance of any series with a preference on voting, dividends or liquidation over this one;
- Redemption or other repurchase of any shares;
- Amendments of the Articles of Incorporation or Bylaws.

Statutes also have mandatory provisions about voting rights. MBCA §10.04.

**Redemption Provisions**

This gives the VC an exit by forcing the Company to redeem its shares if it hasn’t gone public and provided that exit within a period of years, usually 1-5 years, depending on which round it is.
The redemption price is the original purchase price plus accumulated but unpaid dividends and generally something more, such as a multiple of the sum of the purchase price and accrued dividends. Rarely used, because it probably means liquidating the Company, and creditors are ahead of VCs at liquidation.

**Registration Rights:**
This is the desired exit, because it means the company has successfully completed a public offering at a price the VCs are not unhappy with.

**Demand Registration Rights**
This means VC can insist that Company register its stock for public offering. These rights typically don’t take effect until an initial public offering by the Company. This typically requires a demand from holders of a large percentage of all shares of common into which the preferred is convertible. Company will bear the expenses of this registration, except for underwriting commissions. Typically this is a one or two-time right, because registration is so expensive.

**Piggy-Back Registration Rights**
This gives the VC the right to have its shares included in any registered public offering of stock undertaken by the Company. Both founders & VCs want this to occur. There may be multiple registration rights, because it adds little to the cost of registration. Company may want to reserve the right to limit the shares to be registered if advised by the underwriter that the offering is so large that it will lower the price obtainable by the Company.

**Shareholders’ Agreements**
VCs will want to assure representation on the board. Typically the VCs will demand a number of seats equal to those held by the founders, with mutual agreement on one additional director to serve as an independent tie-breaker. VCs will want to restrict the ability of the founders to transfer their shares by acquiring a right of first refusal if founders wish to sell out. VCs may also want to restrict the ability of founders to sell out by providing that Founders’ Shares vest on a schedule.

**Tag along rights** permit preferred shareholders to sell their shares on the same terms offered to any founder or major common stockholder by a third party, whether in a purchase offer or merger or acquisition. They don’t want to be left behind in a company with new controlling common stockholders.

**Drag along rights** permit preferred shareholders with a controlling interest on conversion to force other shareholders to sell out to a third party on the same terms. Many buyers don’t want to retain minority interests when they’re buying control. In mergers, the preferred holders can require the founders and other common shareholders to vote for the transaction.
THE TERMS OF THE DEAL - THE TERM SHEET

The “Then and Now” table illustrates how market conditions can change. The key here is to get current information on the general conditions being imposed when you seek capital. The Technology Association of Georgia (TAG) does periodic term sheet studies. Other term sheet studies are published from time to time – usually for a fee. The most effective way to learn about the best available terms is a wide search for interested VCs. If you’re raising enough money, this may be the time to use a brokerage firm to contact a large number of VCs.

1. **Look at the term sheet in the light of the “then and now” table, and let’s talk about which end of the spectrum it represents.**

   - **Amount of total financing:** ($1 to $3 million, depending on how many VCs join). The low (now) end.
   - **Pre-money valuation:** $5 million. The low end. Made worse by a requirement of net revenues reaching at least 80% of those stated in the Business Plan, or $4 million. If the revenues don’t reach this level, the pre-money valuation falls to: $3.5 million, and investors get more shares.
   - **Dividends:** 8%. That’s good, and is a “Then” type of term.
   - **Liquidation Preference:** 1 X purchase price, plus participation rights up to 4X the original purchase price. Closer to “then.” That’s good.
   - **Redemption:** At option of holders, after 5 years at liquidation preference or market value, whichever is higher.
   - **Automatic Conversion:** Qualified IPO is set at $35 million, which is good, but there are two more conditions: (B) market cap has to exceed $150 million and the offering price has to exceed 3X the purchase price of the A round.

   If a $3 million investment gets the VCS 37.5% of an $8 million post-money valuation, this is $3 million valuation, so the result
must be a $9 million value for the VC’s stock.

Keep in mind that these VCS will be diluted by later rounds of investing, so this isn’t so easy.

Antidilution Protection: Full Ratchet. This is tough, in case of a down round.

Board Composition: 2/5 VCS. The founders get 2, and can choose one more with board approval. Typical.

Protective Provisions: 75% Series A approval required for change of rights or waiver of rights.

2/3 Series A approval for distributions (stock repurchases or dividends), increases in common stock or convertible stock, creation of senior or in pari passu with Series A, or merger or sale; subsidiary stock issues, changes in board size, joint ventures or exclusive marketing or licensing agreements, etc.

Pretty good. More like “Now.”

Pre-emptive Rights: Pro rata purchase of entire new offering, in order to maintain proportionate ownership.

Pretty good. More like “Then.”

Pay to Play Provisions: None. Like “Then.”

First Refusal Rights: Company Right, followed by Series A right to purchase shares offered by any shareholder.

Like “Now.”

Co-Sale Rights: Right to sell along side any other shareholder.

Like “Now.” Not limited to founders.

Drag-along Rights: None. Like “Then.”

Forced Sales: None, but forced redemption after 5 years is equivalent to forcing a sale of the company.
Like “Now.”

Founder Vesting: None, but Founders can’t sell prior to a Qualified IPO.

Reps & Warranties: No requirement that Founders give them (“Standard reps and warranties of the Company for transactions of this type.”)

Like “Then.”

2. **Assuming that the purchase price is non-negotiable, if you could negotiate over two of the terms, which ones would you pick? What arguments would you make for change?**

   A. If it’s not considered a price term, the qualifier on the pre-money valuation, that revenues reach 80% of those in the Business Plan, or the VCs get more stock, is hard. That means they get to avoid the initial risks to some extent.

   B. The Full Ratchet Antidilution Protection is tough if there’s a down round. Founders can get badly diluted.

   C. There is no “pay to play” provision, that forces VCs to participate in subsequent rounds or lose their antidilution rights or their preemptive rights on future rounds.

      New VCs will be looking to the existing VCs for signs of their continuing support of the Company in subsequent rounds.

3. **If the target of at least 80% of the projected revenues in the Business Plan is not achieved, what will the effect be on the purchase price per preferred shares?**

   A. If the pre-money valuation falls to $3.5 million, and the VCs contribute $3 million, they get 46% of the outstanding shares ($3 million investment / post-money $6.5 = 46.1%).

      This means founders will lose control in any subsequent round, but they probably would have anyway.

4. **Examine the Model Term Sheet of the National Venture Capital Association, at [http://www.nvca.org/model_documents/Term_Sheet.DOC](http://www.nvca.org/model_documents/Term_Sheet.DOC). Are there significant substantive differences from the book’s example? (The book’s form was drawn from an actual agreement where the parties were represented by two major Atlanta law firms, although it has been altered for the purposes of this chapter.)**
A. Yes. Some of the differences are detailed below:

**Price:** The NVCA document has a fixed amount to be invested, rather than a range. That simply represents the difference between our term sheet, which is submitted by a lead VC to kick off the process, in the expectation that other VCs will follow along.

**Capitalization:** The NVCA document has a pre and post-financing capitalization table, which clarifies the understandings about valuation and pricing. While this is a good idea, in our form we could only do it on the assumption that $3 million will be raised.

**Option Pool:** The NVCA document (“Employee Stock Options”) provides specifically for the vesting of options - 25% after one year, and monthly vesting over the next 36 months. Sometimes vesting is quarterly. This eliminates later disputes over vesting.

**Use of Proceeds:** Not covered in the NVCA document. But under “Board Matters” in the NVCA term sheet, the series A investors elect one director, which provides monitoring if not control.

**Dividends:** The book’s term sheet calls for 8% cumulative dividends. The NVCA term sheet offers three alternatives under “CHARTER.” Alternative 1 calls for payment on an “as-converted” basis, share and share alike with the common stock. Alternative 2 calls for non-cumulative dividends, and Alternative 3 calls for cumulative preferred dividends. One might ask why anyone would settle for anything but option 3, which is the standard choice in publicly offered preferred stock. Part of this, the author has been told by a former venture capital lawyer, at least prior to 2001, was the divide between West Coast lawyers, whose experience was primarily private offerings (Alternatives 1 and 2) and East Coast (Alternative 3) lawyers, who had more experience with public financings. West coast venture capitalists didn’t want to expand liquidation preferences so much that founders would lose their incentives if success took longer than expected. Since the collapse of the NASDAQ bubble, there has been greater convergence on Alternative 3.

**Liquidation Preference:** Note the triggering events in the book’s term sheet: (1) a transaction of virtually any transaction that leaves current owners with less than 50% of the capital stock (defined as a “Liquidation Event”). This includes a liquidation sale or merger or sale of substantially all assets of the company.

The liquidation preference is the original purchase price plus accrued but unpaid dividends, plus participation (on an “as-if-converted”) basis with the common.

Note the NVCA definition of a Liquidation Event begins with the same terms – a liquidation, dissolution or winding up of the company. A “Deemed Liquidation Event” includes the same mergers, consolidation, or a sale, lease of substantially all assets of the company.
company. Alternative 1 simply calls for payment of the purchase price plus accrued dividends – a modest amount that essentially forces conversion by the preferred holders, if gains from holding common would be greater. Alternative 2 gets the preferred the benefits of Alternative 1 plus participation with the common on an as-converted basis. Alternative 3 gives the benefits of Alternative 2 but caps the participation of the preferred at a stated multiple of the Original Purchase Price.

Conversion: The conversion ratio is 1:1, subject to antidilution protection. The NVCA version (“Optional Conversion”) is the same.

Automatic Conversion: The book’s Term Sheet allows the holders of 75% of the class to force conversion of the entire class. The truly automatic out is an IPO if conditions are met – (i) aggregate proceeds of the IPO exceed $35 million; (ii) the post IPO market capitalization of the company is at least $150 million, and the offering price per share is at least three times the share price of the preferred (a “Qualified Offering”). Note that conversion is essential to a successful public offering. The forced conversion by vote of 75% of the holders allows then to waive the “Qualified IPO” conditions, if most of the preferred holders think the offering is acceptable if not ideal.

The NVCA version is similar.

Antidilution Protection: The book’s term sheet is Full Ratchet. The NVCA version contains a weighted average version (Alternative 1), a full ratchet provision (Alternative 2), and a no price adjustment (Alternative 3). This third alternative leaves the VCs with the same risks as Founders in the event of dilutive later issues. Obviously the Founders don’t want dilution any more than the VCs, and this would be their argument.

Both the book’s term sheet and the NVCA version have carve-outs from these protections for (i) securities issued on conversion of the Series A or (ii) upon conversion of any other preferred stock, or (iii) to company officers, directors or employees on conversion of stock options approved by the Board’s compensation committee. The NVCA version allows issuance if the options are approved by the Board, including at least a specified number of series A directors. The NVCA version contains slightly broader exceptions, for shares issued or issuable to (presumably pursuant to warrants) to banks or equipment lessors pursuant to a debt financing or equipment leasing transaction.

Redemption: The book’s term sheet allows for optional redemption by the Series A investors at any time after five years at a price which is the greater of fair market value (undefined) or the Liquidation Preference. The NVCA version is qualified by calling for redemption only upon the vote of holders of a specified percentage of the class. This prevents individual shareholders from seeking an exit and creating a rush for the door by other holders, who might believe the long-term prospects are worth holding on for. The NVCA
version also calls for redemption over three years, recognizing that immediate payouts are probably legally impossible if made in large numbers. Footnote 11 to the NVCA version observes that where payments are delayed, some provisions will add a penalty, and others provide that the Series A can elect a majority of the board until the redemptions are paid out.

Voting Rights: The book’s term sheet contains the standard – preferred votes on an as-converted basis, and not as a separate class (with a reference to a carve-out). The NVCA form is a little more specific (for clarification) but substantially the same.

Board of Directors: The book’s term sheet for one of the five directors to be named by the lead investor and one by the other investors in the Series A round. The two top officers are to be on the board, and the fifth one is to be designated by the CEO with board approval. Since the board, absent this designee, contains only four directors, this person must be acceptable to both sides, and is often viewed as a tie-breaker. The Series A directors will constitute 2/3 of the Compensation Committee, which gives them control over stock options for officers, directors and employees, as well as cash payments. The NVCA form (“Board Matters”) is much briefer, simply providing that each board committee shall include at least one series A director.

Observation Right: No provision in the NVCA term sheet. One can only speculate about the reasons for this. Being an observer in a private company doesn’t create serious problems, but once the company goes public, any investor with an observer has to deal with whatever confidential information might have been disclosed at board meetings. The company will want to secure a confidentiality agreement from each observer and from each entity with an observer. VCs will face conflicts of interest if they decide to invest in other firms in the same field – prospective competitors – and must be required to create a “Chinese Wall” between the observer and partners considering investment in other entities – an almost impossible obligation to enforce.

Protective Provisions: The book’s term sheet provides for a 75% vote of the Series A before actions that adversely affect the Series A. In many jurisdictions, such as Model Act states, this protection is provided by MBCA §10.04, which requires class voting on such matters, although not a 75% vote. For a range of other matters, the term sheet requires a 2/3 class vote. Some of these are also covered by MBCA §10.04 and §11.04 (for mergers), but not by a supermajority vote. Surprisingly, none of these are covered in the NVCA form.

Events of Non-Compliance and Remedies: The book’s term sheet covers breach of any covenant protecting the Series A that is not cured after notice and a reasonable time, or any bankruptcy, receivership, assignment for the benefit of creditors or unsatisfied judgment. These events give the Series A the right to elect a majority of the board.
NVCA form does not address these issues. The author’s view is that addressing breaches and remedies is always a good idea.

**Capital Expenditures, Assumption of Debt and Guarantees:** The book’s term sheet calls for a capital budget to be approved by the board, and for any (additional) capital expenditure greater than the approved budget by $50,000. Approval of the Series A holders is required for assumption of debt or guarantees in excess of $1 million. (Note that this provision doesn’t state what percentage of the Series A is required for approval.) The NVCA form does not have a budget approval provision, but the “Protective Provisions” contain a requirement for Series A Director approval of assumption of debt in excess of a stated limit.

**Information Rights:** The book’s form requires delivery of audited annual financials, quarterly financing and operating statements, an annual operating plan, standard inspection and visitation rights, and monthly reports of operations. The NVCA form (“Management and Information Rights”) requires, in addition, monthly financial statements, a comprehensive operating budget in advance of each fiscal year with cash flow forecasts month-by-month, and a quarterly capitalization table. This seems to anticipate more frequent financings, and perhaps a broader group of investors in the Series A round who won’t have observers. The requirement of a comprehensive operating budget and month by month cash flow forecasts is more detailed and perhaps less likely to result in disputes about the content of the annual operating plan.

**Representations and Warranties:** The book’s term sheet doesn’t differ from the NVCA form (Set out under the “Stock Purchase Agreement”). While at first blush this seems vague, one could refer to the Stock Purchase Agreement on the NVCA site for standard content.

**Registration Rights:** The book’s form calls for two demand rights and unlimited piggy-back and short form registration rights. The NVCA form (under “Investor Rights Agreement”) provides either one or two demand registrations and unlimited piggy-back registrations. With respect to demand registrations, it provides for holders of a minimum percentage of shares to demand registration. It also provides that once the company is eligible to use Form S-3, holders of [10-30%] of the shares can demand registration, with a minimum offering price requirement [$1-5 million]. This is pretty generous. The NVCA form is much more specific about expenses, lock-up agreements and termination of registration rights.

**Rights of First Refusal:** The company, and if the company declines, the remaining Series A holders will have a right of first refusal to purchase shares offered for sale by shareholders. This presumably includes both common and preferred shares, although it doesn’t specify. The NVCA form (“Right of First Refusal/Co-Sale Agreement and Voting Agreement” - “Right of first Refusal/Right of Co-Sale (Take-me-along) provides
the company, and if the Company declines, the “Investors” (not a defined term but apparently only the Series A investors), a right of first refusal on “any shares of capital stock” (clearly both common and preferred).

**Tag Along Rights:** The book’s term sheet gives the Series A Investors “standard TagAlong Rights with respect to any proposed sale of common stock. The NVCA form (“Right of First Refusal/Co-Sale Agreement and Voting Agreement” - “Right of first Refusal/Right of Co-Sale (Take-me-along) is the same.

**Founders Shares:** The book’s form prohibits two named Founders from selling any common stock before a Qualified IPO. No similar provision in the NVCA form. This suggests that Founders could sell out before a Qualified IPO, and the only protection the Series A Investors would have would be tag-along rights, perhaps at an earlier stage of development than the Series A Investors would prefer. The protection (Other Matters: Founders’ Stock) would be the right of the company to buy back Founders’ shares at cost, which would wipe out the Founders’ incentive to sell out. On the other hand, this buy-back right is a dangerous one for the Founders if a second round of financing should lead to a majority of VC representatives on the board. This rarely happens, as board representation is typically equal with one neutral party.

**Pre-Emptive Rights:** The book’s form gives the Series A holders preemptive rights to purchase any class of equity securities, based on the holder’s percentage of the fully diluted outstanding shares of the company, with an exception for a Qualified Public Offering, and terminating upon a Qualified Public Offering. [Query: is “fully diluted outstanding shares” an oxymoron? Normally fully diluted includes both convertible securities and shares issuable upon exercise of stock options. Second problem: does the holders’ percentage of outstanding shares mean on an as-converted basis?] The NVCA provision (“Right to Participate Pro Rata in Future Rounds”) is specific about rights existing on an as converted basis and assuming exercise of all options, with an exception for those items listed at the end of the anti-dilution provision: carve-outs for (I) securities issued on conversion of the Series A or (ii) upon conversion of any other preferred stock, or (iii) to company officers, directors or employees on conversion of stock options approved by the Board’s compensation committee. The NVCA version allow issuance if the options are approved by the Board, including at least a specified number of series A directors. The NVCA version contains slightly broader exceptions, for shares issued or issuable to (presumably pursuant to warrants) to banks or equipment lessors pursuant to a debt financing or equipment leasing transaction.

**Conditions Precedent to Closing:** The book’s term sheet conditions the closing on completion of (I) due diligence to the investors’ satisfaction; (ii) completion of mutually satisfactory legal documentation; (iii) no material adverse change; (iv) satisfaction of other customary conditions to closing as set forth in the Stock Purchase Agreement (which normally
hasn’t been drafted yet, so reliance on the NVCA form would be appropriate); and (v) necessary committee/board approvals for each Investor. The NVCA “Conditions to Closing” add qualification of the shares under applicable Blue Sky laws, a filing of a certificate of incorporation establishing the rights and preferences of the Series A, and an opinion of counsel to the Company. Note the contents of this opinion aren’t specified, but you can assume that it will cover the valid existence of the company, proper authorization of the new issue and authorization of the adoption of the amendments to the articles of incorporation specifying the Series A preferred, and authorization of corporate officers to take all actions necessary to execute the documents and file the amendments with the Secretary of State.

Non-Competition Agreements: The book’s term sheet requires both founders to sign non-competes “in form and substance reasonably satisfactory to the Investors.” The NVCA form (“Non-Competition and Non-Solicitation and Agreements”) calls for a one-year agreement. It covers both Founders and key employees. The reference to “non-solicitation” is typically an obligation not to solicit customers of the business, but it could be expanded to cover solicitation of the Company’s employees.

Confidential Information and Invention Assignment: The book’s form provides that every employee will enter into such an agreement. The NVCA form (“Non-Disclosure and Developments Agreement” expands the group to cover each current and former Founder, employee and consultant with access to confidential information to enter into a non-disclosure “and proprietary rights assignment agreement.” This is clearer than the book’s form.

Legal and Due Diligence Expenses: The book’s form requires the Company to pay reasonable fees and expenses of the VC’s counsel, together with the VCS’ “other reasonable out of pocket expenses.” The NVCA form (“Stock Purchase Agreement – Counsel and Expenses”) caps the legal fees payable by the Company, and excuses the company from this obligation if the VCS withdraw their commitment without cause. It also provides an option for which party will draw the closing documents.

Exclusivity: The book’s form gives the VC an exclusive right to deal with the Company for 45 days, during which time the Company cannot solicit better offers, although it can solicit other VCS to join in this transaction. The NVCA term sheet (“Other Matters - No Shop/Confidentiality”) gives the VCs six weeks with no exceptions – if the Company is approached by any investors the Company must simply notify the VC.
WHAT’S MISSING FROM THIS FORM?

Pay to Play: As noted earlier, there is no “pay to play” provision that forces VCs to participate in subsequent rounds or lose their antidilution rights or their preemptive rights on future rounds.

Key Person Insurance: The NVCA form requires the company to maintain life insurance on the Founders, payable to the Company.

IPO Directed Shares: The NVCA form requires the Company to reserve 10% of an IPO as directed shares, with half being allocated by the Major Investors.

QSB Stock: The NVCA form requires the company to cause its stock to constitute Qualified Small Business Stock unless the board determines that’s not in the interests of the Company. Section 1202 of the Internal Revenue Code allows exclusion of 50% of gains from the sale or exchange of QSB Stock held 5 years or more. A qualified Small Business must have aggregate gross assets of less than $50 million dollars and be engaged in an active business. It must also be a C corporation. There are certain exclusions in the statute.

Drag Along: The NVCA form provides that the Series A Investors and the Founders and large (greater than 1%) holders of common will agree to vote for a “Deemed Liquidation Event” approved by the Board of Directors and holders of a specified majority of the Preferred. A “Deemed Liquidation Event” includes any merger or consolidation in which 50% or more of the voting power of the Company is transferred or a sale, lease of substantially all assets of the company.

Existing Preferred Stock: There is a provision that any changes needed to conform to the terms of existing preferred stock to the terms of this term sheet will be made at the closing. Obviously that doesn’t apply to a Series A round.