

# Term sheets and venture capital investors

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Most venture capital (VC) investors use a standard form term sheet for their investments. Term sheets play an important role as they ensure that difficult commercial discussions take place at an early stage in the investment process. There are similarities in the key terms and trends in term sheets used by VC investors in the UK, France, Germany, Italy and the US, due to increasing standardisation of terms. In addition, European VC investors have historically followed the lead of their US counterparts who operate in the most developed VC market worldwide.

Against this background, this article looks at:

- The economic climate.
- Term sheet trends.
- Key terms.

## ECONOMIC CLIMATE

VC fundraising activity in the US and across Europe declined in 2009. In the US, fundraising was at its lowest since 1993, totalling US\$15.2 billion (about EUR10.3 billion) from 120 funds, a 47% decline by dollars committed (*Despite Fourth Quarter Increase Venture Capital Industry Experience Slowest Annual Period for Dollars Committed Since 2003, Thomson Reuters & National Venture Capital Association, 11 January 2010, www.nvca.org*). In Europe, venture capitalists invested US\$4.4 billion (about EUR3 billion) in 916 deals (41% decrease from 2008) (*Dow Jones VentureSource*). In the fourth quarter, VC investors put in US\$1.3 billion (about EUR883 million) into 252 deals (28% decrease from the same period in 2008).

## TERM SHEET TRENDS

The decline in funding and the overall economic climate resulted in certain term sheet trends across the jurisdictions covered by this article, including:

- **Later-stage investments.** A focus on later-stage investments in proven technologies and companies rather than first round investments.
- **Decreased pre-money valuations.** A decrease in the pre-money valuation amount of companies, partly due to VC investors anticipating lower multiples being achieved on exit.
- **Lower deal values.** The median value of a European venture capital deal dropped 24% from EUR2 million (about US\$2.94 million) in 2008 to EUR1.6 million (about US\$2.4 million) in 2009 (*Dow Jones VentureSource*). The typical first round investment in an early-stage European company is now between EUR1 million (about US\$1.5 million) and EUR2 million.

- **Tranched financing.** The increased use of tranched financing through which a company must meet performance milestones to receive funds in addition to those invested in an initial closing. In some cases, milestones agreed in term sheets have been extended or modified as VC investors recognise that failure to meet them may be due to the economic environment rather than a company's structural problems.
- **Downward price adjustment.** Particularly in the US, more common use of issuing additional shares to investors and the downward adjustment of the price per share paid due to failure to meet performance milestones.
- **Pay to play.** Particularly in the US, an increase in the use of pay-to-play provisions, under which investors who fail to invest in a subsequent financing round have some or all their shares converted to shares without any preferred rights on closing of the subsequent financing round.
- **Venture debt.** In the US, and to the extent available in the UK, there is an increased use of venture debt (generally, secured debt) financing with higher interest rates than ordinary bank debt. The debt is frequently accompanied by a warrant or equity kicker. In the US this is typically 5% to 20% of the loan amount.
- **Ratchets.** Ratchet mechanisms (providing for a valuation adjustment), though not often seen in earlier stage investments in the UK, are now increasingly common (particularly in France).

## TERMS

There are similarities and trends across jurisdictions in relation to the key provisions used in term sheets.

### Shares

Most term sheets provide for preference shares (preference stock in the US and special shares in Italy) to be issued to the VC investor with the founders of the company receiving ordinary shares (or their country-specific equivalent). In determining the number of preference shares to be issued and the issuing process, consideration must be given to local legal and accounting issues. For example in Italy, the corporate capital of a joint stock company can only have up to half its shares in the form of preferred shares.

- **Preference Shares.** The vast majority of VC investors insist that shares issued to them to have preferred rights. The preferred rights are generally economic and include:

- **A fixed dividend.** Fixed dividend rights are typically in the region of 6% to 12% of the amount invested (6% to 8% in the US). The right to a fixed dividend is not universal. If there is a fixed dividend, there is often discussion at the term sheet stage concerning whether it accumulates (as accumulation can have a significant effect on the total return if exit occurs a number of years after the investment). In the UK and France, the general trend is not to have a dividend which accumulates. In the UK, this is partly because under International Financial Reporting Standards (IFRS) and UK generally accepted accounting principles (GAAP) dividends which accumulate can be regarded as liabilities on the company's balance sheet. This can create issues when dealing with third parties including suppliers and customers;

- **A liquidation preference.** A liquidation preference ensures that a VC investor is at the top of the list to receive cash in the event of a liquidation or a deemed liquidation. A deemed liquidation typically includes a merger, asset sale and sometimes an IPO. The amount of liquidation preference is a function of perceived risk and the overall valuation of the company. For companies not regarded as inherently risky, a liquidation preference of one times the amount invested (plus any accrued but unpaid dividend) is relatively standard in the UK and Italy. However, term sheet negotiations frequently start with a multiple of two or greater;

Although there has been a trend towards increasing the amount of the liquidation preference, there has not been a widespread return of aggressive liquidation multiples (such as a multiple of five) seen during the 2001 technology downturn. Liquidation preferences are often capped so that the VC investor receives, in the aggregate, the greater of the preference multiple or the amount the holder would receive if all preference shares had been converted to ordinary shares immediately before a liquidation;

- **Rights to participate.** VC investors generally require their preference shares to be participating so that once the liquidation preference is paid, the preference shares participate alongside ordinary shares. There are often caps on the participation element so that a VC investor receives, for example, a preference multiple of one and participate up to a multiple of three;
- **Rights of redemption.** In the US, holders of preference shares typically have the right to call for redemption of preference shares three to five years after the purchase date. However, the right is not universal across other jurisdictions and it is rare in the UK. If a redemption right exists, it is usually at a price equal to the original purchase price of the preferred shares plus all accrued but unpaid dividends. Redemption rights, particularly if coupled with a preferred dividend, can be problematic under certain accounting standards as they may be required to be treated as debt on the company's balance sheet;
- **Veto rights.** Typically, VC investors have veto rights on (or the right to vote on and block) certain matters including changes to share capital and the creation of new share classes. In Italy, these rights often attach to the shares although in other countries, such as the UK, they are often contained in the investment agreement;

- **Ordinary shares.** Founders (and any employees holding shares) are generally issued ordinary shares. These shares have voting rights and a right to receive dividends declared (if there are no preference rights in favour of the investor) but no other specific rights. For tax reasons, growth shares (which are often non-voting) are sometimes issued to employees instead. Growth shares participate on an exit (alongside ordinary shares) if the exit has a value above a set level. Ordinary shares generally have an issue price below the preference shares, given the rights attaching to them.

### Anti-dilution

Although there is no standard position, most term sheets include some form of anti-dilution protection for VC investors. The mechanics for effecting the anti-dilution protection vary between countries, though the form of protection is commonly a full ratchet or a weighted average (either broad based or narrow based). Full ratchets, while providing the greatest protection to the investor, are generally resisted and are uncommon in the UK. Despite the downturn, VC investors have not generally insisted on a full ratchet except if there has been a high pre-money valuation.

### Founders and leaver provisions

The general trend is for founders to own their shares outright with an option for the company or other shareholders (depending on local law issues) to buy back the shares in certain circumstances, for example if the founder becomes a leaver. Often, unless a founder is a bad leaver, the buyback right only applies to a portion of the shares and for a set period after which time the right lapses.

The extent to which buyback provisions have been judicially tested varies between countries. In Germany, good and bad leaver buyback provisions have recently been validated by the Federal Supreme Civil Court. In France, good leaver and bad leaver provisions are more prone to challenge as they must be carefully structured to ensure compliance with French employment law.

In addition to buyback provisions, founder shares are often subject to a lock-in for a set period. However, there can be local law restrictions in setting the period. Under Italian company law there can only be a lock-in for a period of five years after the closing of the investment.

### Rights of pre-emption

VC investors generally have a right of first refusal in relation to:

- Any further issue of shares (except for approved issues such as to employees under a share option plan). This right is separate from anti-dilution protection.
- Any transfers of shares by founders, that is, before a founder can sell his shares, he must give the VC investors an opportunity to participate in the sale. Certain exceptions are usually negotiated, such as estate planning or *de minimis* transfers. Transfers are sometimes also prohibited to competitors or to other parties to protect confidential information.

In the US, VC investors do not ordinarily have any right of first refusal in relation to transfers of shares held by other VC investors. In contrast, in the other countries covered in this article, this is usually negotiated. However, in light of the number of secondary

buyouts over the last 18 months, where VC investors have had to go through a right of first refusal, it is increasingly common in the UK for VC investors to insist there is no right of first refusal on the transfer of their shares.

### Drag-along rights

In the vast majority of term sheets, VC investors insist on including drag-along rights under which an agreed percentage of the shareholders can force a 100% share sale (and, in the US, other types of exit events). In the US, a drag-along right is often triggered where 50% or more of the voting power of the company is transferred. In the UK and the US, this is calculated by reference to the common shares, any preference shares being deemed to have been converted. In contrast, in Italy and France, a drag-along right is frequently only triggered at 90%. In Italy, in addition to the requirement that 90% or more of the voting power of the company is transferred, there is often a requirement that a minimum price is paid on the sale of the company. In Germany, drag-along rights are often tied to a date, and if an exit has not occurred by this date, the tendency is to change the date rather than use the drag-along right. Any exercise of the draft right is usually also subject to investor majority consent.

Particular attention has been paid to drag-along rights in the UK over the last 12 months as VC investors must increasingly rely on them since exits are not taking place at the anticipated multiples.

A drag-along right is typically coupled with tag-along rights enabling minority investors to exit at the same time as the VC investor.

### Representations and warranties

It is relatively uncommon for all representations and warranties (typically just warranties in the UK) to be set out in the term sheet. Instead, reference is made to customary representations and warranties. These representations and warranties are often given by both the company and the founders and address key issues in relation to the company. Each founder's liability is often capped at a percentage value of the investment or a multiple of their salary. In France, linkage must be structured carefully since linking the cap to a multiple of salary can be problematic as it risks breaching labour law.

Founders' representations and warranties are uncommon in the US for subsequent rounds by the same investors, where VC investors consider the risk to be lower and to be shared by the investors rather than being disproportionately borne by the founders. However, they are still relatively common in the UK for subsequent rounds.

### Board of directors

It is now standard in most term sheets for VC investors to have a right to appoint someone to the board of directors. The structure of this right depends on whether the company, as a matter of local law, has a unitary or two-tiered board.

**US, UK and Italy.** A company taking VC investment ordinarily has one board of directors (board), which manages the business and affairs of the company. Most VC investors insist on having the right to choose at least one board member. In addition, VC investors often have the right to appoint a board observer who attends board meetings and receives the materials provided to the board, but does not have a right to vote on matters before the board.

**Germany and France.** In France and Germany, VC-backed companies ordinarily have a two-tiered board system, that is, a management board and a supervisory (or advisory) board. VC investors require representation in the supervisory board rather than the management board. Control rights are exercised through the supervisory board. The two-tiered board structure allows investors to limit liability connected to the decision-making organ while maintaining involvement on the supervisory board.

Although often resisted by founders, certain corporate acts (relating to for example, debt obligations, related party transactions and employment matters) are often subject to the approval of the VC board designee. However, in structuring any director consent (rather than VC investor consent), potential conflict issues for the director must be considered.

### Information rights

In addition to a VC investor's statutory right to information (such as the right, in Italy, to access corporate books and examine draft financial statements before a shareholders' meeting), term sheets usually set out extensive information rights for investors. Information rights typically include an obligation to provide monthly, quarterly and annual financial statements and a budget. Budgets are usually subject to the prior approval of VC investors.

Information rights are negotiated in relation to whether they remain in effect while the investor holds any of the company's shares or whether the investor must maintain a specific level of ownership to have such rights.

### Exits

Across the jurisdictions covered, the average target date for an exit is around five years from the date of initial investment. However, VC investors are aware that the date is driven by the current market and the company's position in terms of its life and investment cycle.

Exit events typically consist of IPOs (initial public offerings) and M&A transactions. During the dot-com bubble of the late 1990s, IPOs were a viable exit strategy particularly in the US for many VCs. Exit times were also often truncated.

Since the dot-com crash and particularly with the current state of the economy, many VC investors have reset exit expectations over a longer horizon and M&A transactions have become the primary means of exit. In the US, 2008 and 2009 have been the slowest consecutive years for US venture-backed IPO activity since 1974 to 1975. However, in 2009 there were 13 venture-backed IPOs (including five in the fourth quarter) and 262 M&A transactions (including 67 in the fourth quarter with the highest quarterly average value based on disclosed deals since the fourth quarter of 2007) (*Venture-Backed Exit Market Improves Marginally at Year End; M&A Exits See Highest Average Value Since Fourth Quarter 2007 While IPO Market Shows Preliminary Signs of Life*, Thomson Reuters & National Venture Capital Association, 4 January 2010, [www.nvca.org](http://www.nvca.org)).

### Confidentiality and non-compete obligations

VC investors perform due diligence on a company before investing, including verifying that the company owns its intellectual property. As part of this verification, VC investors often require

company founders, employees and consultants to execute a confidentiality and invention assignment agreement in a form acceptable to the VC investor as a condition to investment. Such agreements typically provide for protection of the company's confidential information including:

- Non-disclosure.
- Non-competition/non-solicitation obligations (in some cases).
- Disclosure of prior knowledge, inventions and commitments that conflict with obligations to the company.
- Disclosure and assignment of inventions to the company (typically those related to the company's business or made with use of the company's resources).

Most term sheets provide that founders enter into non-competition (and non-solicitation) undertakings. The duration and scope of these undertakings is a matter of local (and, in the US, state) law given that such undertakings can be subject to adverse judicial scrutiny. For example in France, non-compete provisions generally continue for two to five years once the founders or key employees have left and are subject to French labour law. In contrast in Germany, non-compete provisions are typically for the length of employment. Post-employment, non-compete provisions are rarely seen in Germany as they require compensation payments. In the UK, non-compete provisions often apply while a founder holds shares and for a period of six to 12 months after ceasing employment.

#### Employee share option plans

To incentivise employees, many companies adopt share option plans or employee share ownership plans, under which the company grants key employees the right to acquire shares in the company. In Europe, the typical share option plan is up to 10% of the issued share capital. Vesting of the shares or options is common. It is not uncommon in the UK to see a four-year vesting period with a one year cliff, so that for example, 25% vests after 12 months and the remainder vests monthly or quarterly for 36 months.

How these plans are structured is often driven by local tax law. For example in Italy, stock options are no longer attractive as current tax law treats them as equal to earned income so that taxation is the same.

#### Conditions precedent

Term sheets do not generally contain detailed conditions precedent, as the term sheet itself is non-binding. Instead, conditions precedent are typically included in the investment documents. The conditions can vary greatly depending on the concerns of VC investors.

#### Other terms

There are a number of other terms often included in term sheets across the countries surveyed including:

- Exclusivity provisions.
- Payment of VC investors' fees.
- Key man insurance in relation to the founders.
- D&O insurance in relation to officers.
- On US deals, registration rights and ERISA management rights.

#### Local law requirements

Confidentiality and exclusivity obligations in term sheets must be valid and binding. Local law formalities must be addressed to ensure this. For example in Germany, a term sheet relating to a GmbH must be notarised to be valid.

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