The Kinder, Gentler 2004 Venture Capital Term Sheet

By Michael Siavage

The bust of the ".com Boom" engendered venture capital term sheets with increasingly onerous provisions that unfavorably impacted emerging companies seeking financings. Liquidation preferences (the payment to the venture capitalist ("VC") prior to any payment to other stakeholders of the proceeds of any liquidity event) equal to three times the venture capital investment were common and full ratchet anti-dilution (requiring the entire equity percentage of the VC to be increased as a result of any sale of securities for a lesser price) were standard. Company founders, angel investors and, to an even greater extent, company option holders began to face situations where there was little light at the end of the tunnel. The terms offered by VC's became even strident in the quarters subsequent to Q3 of 2001 and investments later all but dried up except for "follow-on" rounds where the VCs had little choice but to invest further in promising companies.

Such follow on investments were completed with increasingly draconian terms for a few quarters and then began to shift. VC's began to soften terms for several reasons: 1) management teams, demoralized by the realization that their day in the sun might never come, were losing their zeal; 2) a high profile lawsuit[1] by a management team whose equity position had been diluted to a miniscule percentage of the outstanding equity was settled rather than litigated thus avoiding what could have been disastrous precedent; and perhaps most importantly 3) no manner of VC-favorable term sheet would achieve the goal of a good return for the limited partners if the company was not successful in the first place—a significant increase in company valuation fosters a good return for the VC much more efficiently than a high liquidation preference in a company disposed of in a fire sale.

This article will review certain of the most critical VC term sheet terms typically found in early venture rounds and will discuss their significance. It will also explain how many of the important VC terms have been rationalized to a degree that is much more favorable to the entrepreneur.

As a preliminary matter, however, it is worthwhile to discuss the relative importance of some of the standard terms in the VC term sheet. For instance, a sizeable amount of term sheet space is often devoted to issues relating to registration rights (the rights related to the ability of the VC to include the purchased shares in public offerings). While negotiating such a right may be intellectually stimulating, the reality is that registration rights will be negotiated repeatedly in follow-on rounds so that the Series A and Series B registration rights agreements are often superceded. Likewise, many VC term sheets request redemption rights (the ability of the VC to require the company to buy back the securities at a price that often includes interest and dividends at a specified date in the future); however, for the reasons stated below, the entrepreneur would be well advised not to focus significant negotiating effort on the redemption clause.

So what does matter? The answer varies somewhat based upon economic conditions and the limited partnership agreement of the fund that the VC represents. There is some empirical information[2] that suggests that while certain standard terms such as liquidation preferences, cumulative dividends, participation with other equity holders after the liquidation preference is satisfied and dilution protection will maintain their attractiveness, the increasing inclination of VC's to be involved in the management of the company has

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[1] *Kalashian v. Advent VI L.P. (Santa Clara Sup Ct., filed March 23, 1994 No. CV739278).* The case, sometimes referred to as *Alantec* for the company involved, was based on the allegation that the plaintiff founders were diluted to their .007% position through the malfeasance of the investor Board representatives agreement to accept financing at less than fair market value thereby causing the founders economic position to dilute from an alleged $40 million to $600,000. After eighteen days of trial testimony, the case was settled by the VC defendants for $15 million. *See generally*, Padilla, J., *What's Wrong With a Washout: Fiduciary Duties of the Venture Capitalist Investor in a Washout Financing*, 270 Houston Business and Tax Law Journal, Vol. 1, 2001.

[2] See *2004 Issues and Trends in Private Equity and Venture Capital*, Edited by R. Barrett and J. Bartlett. published by VC Experts.com., Inc., 2004.

given rise to requests for one or more seats on the Board and a role in the selection of the CEO. This trend is favorable to both the entrepreneur and the VC. Stung by the numerous and in some cases remarkable management failures of the .com Boom, many VC's now focus on adding Board members and management personnel experienced in the funded company's business and industry. Such board members often add a list of strategic contacts to the company's database that can prove invaluable, particularly as the company grows and matures.

The following are some of the more notable term sheet terms that have undergone change:

1. **Valuations and Investment Size.** Currently, there is a large sum of uninvested venture capital existing in US funds.[3] This and other factors have fostered, for the first time since 2001, a return of a healthy competition between VC's for attractive opportunities. As a result, the downward pressure on valuations has appeared to subside. In addition, many VC's who would formerly not consider an investment, or at least participation in a round of investment, under three million dollars are now approaching entrepreneurs with offers of one million dollars or even less in some instances. This is partially a result of an effort to participate in good deals as soon as possible, but it can also be viewed as an attempt to get the fund invested even if it involves placements of smaller pieces.

This is good news for the entrepreneur. VC's typically aim to control 35 to 45% of the equity of the emerging company. When they enter for a smaller investment, they often foresee a follow on round that achieves such a stake. This math suggests initial valuations between three and five million dollars on a pre-money basis, a welcome change from post-Bust terms sheets where many valuations were less than two million dollars.

2. **Liquidation Preferences.** Each quarter since the Q1 of 2003 has seen a higher percentage of deals with 1X liquidation preferences[4] to the point where currently the 1X liquidation preference has again become the rule. This is a substantial change from the post-Bust term sheet which often contained liquidation preferences of 2X and 3X and where preferences in excess of 5X often appeared.

3. **Participation.** VC's will often specify that the security being purchased is participating preferred stock. This participation feature means that, once the liquidation preference is satisfied, the preferred holders will participate with the common stock holders in dividing the balance of the funds received by the company in the liquidating event. While participation remains a feature of most early round terms sheets, the level of VC participation has been capped in an increasing number of financing rounds. Because the conceptual basis of the liquidation preference is down side protection for the VC, it is possible for the entrepreneur to argue that the upside participation should be capped at some level so that the anticipated returns (above the level of the liquidation preference) are insured while only the founders and option holders take advantage of an event resulting in substantial multiples of original valuation.

In the alternative, the VC might receive a Liquidation Preference in excess of 1X that provides the VC with a fair return on the investment (often 1X plus the VC's expected internal rate of return) *and* the option to reject the Liquidation Preference by converting to common stock instead where conversion to common would provide a better return. In such a case, the VC is protected on the downside but is not allowed to use the downside protection feature as a means to double dip.

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3 See, Oreskovi, Alexei, *Venture Capital Funds Sitting on Scads of Money*, Advising Start-Up and Emerging Companies, Vol. 4 Number 4, March 2004 wherein the author estimates the size of the uninvested pool to be $68 billion.

4 There are a number of quarterly surveys completed primarily by law firms on the frequency of different types of VC terms. Surveys published by Fenwick&West and Fish and Richardson have been used as source material for this Article; see *also* Barrett and Bartlett, *supra*, note 2 which contains numerous such surveys.

4. Redemption. Redemption rights, a staple of post-Bust term sheets appear in only about half of the term sheets currently. For one thing, redemption rights create accounting complexities for the emerging company and the VC.[5] In addition, redemption rights are seldom if ever triggered by the VC. This is because (a) if the company has sufficient cash or borrowing capacity to satisfy the redemption right payment to the VC, the VC is well advised to leave the investment undisturbed in anticipation of a much more attractive payout as a result of liquidation event and (b) if the company cannot make the payment, the trigger is tantamount to a call for involuntary liquidation.

5. Anti-Dilution. Full-ratchet anti-dilution became a very common feature of the post-Bust term sheet. Full-ratchet dilution means that if the company sells even one share of a security at a lower price than the VC investment, the entire VC investment is then deemed to have been placed at that lower price, thereby requiring the issuance of additional shares to the VC and, of course, a higher percentage ownership. Weighted Average anti-dilution is a much more common anti-dilution term in the 2004 term sheet. In weighted average anti-dilution, the shares owned by the VC are increased only in proportion to the lower price of the subsequent investment or issuance and the size of the investment or issuance at that lower price. . For example. if an investment of 10% of the size of the VC investment is made at a price that is 10% lower then the VC investment, the VC percentage of equity will increase by only 1%.

6. Registration Rights. Registration rights are broken down into three customary categories: demand rights, S-3 rights and "piggyback" or discretionary rights. A demand registration right is the right of the VC to require the company to register the VC shares for public sale. This right can be granted so that the VC controls the timing of the IPO or it can be effective subsequent to an IPO in which case the VC can require further public registrations. Piggyback or discretionary rights are the right of the VC to include the VC's shares in any public offering that the company decides to make independent of any input from the VC. S-3 registrations refer to the form upon which such registrations are made; they are made subsequent to an IPO and require substantially less formality (and less cost) than the original registration. Demand rights were almost always required in 2002 and early 2003. 2004 term sheets quite often require only piggyback and S-3 registration rights

7. Pay to Play. Pay to Play[6] provisions are terms that require the investors in one round to participate at least at the same level in future rounds or face losing the preferred rights acquired in the prior round. For example, if a VC acquires a pre-emptive right in the Series A Preferred round that has a Pay to Play, it must invest at least the same amount (or percentage of the raise) in the Series B Preferred round or it's pre-emptive right (and all other preferred rights) terminate. Pay to Play provisions are seen with increasing frequency in 2004 term sheets and this is favorable to the entrepreneur. The term simplifies the company's capital structure while clearing the way for investors in follow on rounds to invest without the concern that prior investors might have veto or blocking rights.

8. Stock Options and Restricted Stock. The realization that the key employees must remain incentivized has caused many VCs to offer the key managers additional restricted stock or options as part of the funding round. Such an overture was never heard during the months after the .com Bust and is a sign of increased VC pragmatism. At the same time, VCs are requiring the size of the employee option pool to be increased prior to their investment so that options can continue to be granted to the growing workforce. Waiting until after the round to increase this pool causes the VC to suffer the dilution, so this trend is not quite as magnanimous as it may appear.

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[5] If the Redemption Right is structured in a fashion that exposes it to Section 305 of the Internal Revenue Code of 1986, as amended, the Company must apply variable accounting techniques; and the VC may have to recognize income on a yearly basis during the term of its investment.

[6] While the term has come to be known as "Pay to Play", meaning the VC must invest to continue to participate, it was originally and, in the writer's opinion, correctly known as "Play or Pay", meaning that if the VC did not "play" in the current round, it "paid" by losing its preferred rights in the prior round.

It is unfortunate that many of the companies that have survived over the last three years without venture financing, whether as a result of large friends and family rounds or boot strapping, have become somewhat negative on the prospect of accepting venture finance. It is sometimes difficult for such a company to pause long enough to review the business plan in an effort to gauge the benefit that a large infusion might have on the stakeholders. The gradual temporization of VC term sheets would suggest that it may be time for such companies to make such an effort. In addition, companies seeking first time financing should be comforted in the knowledge that the climate for VC financing has warmed considerably.

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Highlights from the Executive Committee

Meeting Date: April - July, 2004

By Michael K. Stewart

The Executive Committee of the Technology Law Section has met five times since the last issue of *Technology Law*, on April 20, May 25, June 22, July 27 and August 25. What follows is a summary of the first four of those meetings.

April 20, 2004

Ann Moceyunas chaired the meeting.

Newsletter: Details were discussed regarding upcoming Newsletters, including the fact that the Fall 2004 Newsletter would not have a focus topic. Ann Moceyunas and Michael Stewart indicated that they would work together on guidelines so that summer associates could be encouraged to contribute to future issues of the Newsletter.

Website: Stephen Combs, Webmaster, reported that he has updated the content of the Section Website, ***www.computerbar.org*** with PowerPoints and other materials from the Technology Showcase. The Newsletter is also updated on the Website and eventually Website visitors will be able to search the Newsletter by metadata. The new design of the website will include a Calendar of Events that contains upcoming Section events, rather than a historical record. In a future meeting, Stephen indicated that he would share Website traffic information with the Executive Committee.

Quarterly Meeting Process: Ann Moceyunas reported that she is developing a timeline and checklist for organizing quarterly meetings. Ann indicated that she would add an item to this list to obtain permission to post the speakers' materials and PowerPoints on the Section Website. Ann requested that people send her other suggestions.