**IMPORTANT THINGS TO KNOW ABOUT TERMS SHEETS**

**Pre-money Valuation:** Equals the value the new investors are placing on the enterprise prior to their Investment. Usually, all of the outstanding stock of the company, together with any outstanding options and warrants or other rights to buy stock of the company and any additional shares which may be reserved under the option pool, will be included in this pre-money valuation.

**Stock Option Pool:** The size of the option pool that venture capital investors will look for tends to range between 15% and 30% of the capital structure of the company. This percentage is calculated including the shares of Series A Preferred Stock being sold in the financing. The actual size of the pool can depend on a number of things, including the industry that the company is in, but is primarily related to the number and types of hires that the company will need to make in the foreseeable future. Thus, a company that has a complete management team at the time of the Series A round will likely need a smaller pool than a company that has one or more top management hires to make (each of whom may cost the company a significant amount of options or stock from the pool).

**Dividend:** Often, venture capital investors also ask for an “accruing” dividend of between 8% and 10% or so per annum. This dividend “accrues” and is not payable unless (i) declared by the Board, (ii) there is a liquidation event (a sale of the company is considered a liquidation event, but an IPO usually isn't), or (iii) the preferred stock is redeemed. The accruing dividend is a protective device intended to provide a minimum rate of return but is usually forfeited in the event of an IPO or otherwise upon conversion of the preferred stock to common stock. (The theory is that in such cases the return on the investment will be more than the minimum which the accruing dividend provides. Therefore, the protection is not needed and is forfeited). There are a number of varieties of accruing dividends, including those that are payable in cash and those payable in additional shares of preferred stock. Also, although a basic “accruing dividend” involves a simple interest calculation, sometimes a so-called “cumulative” accruing dividend is requested, and it involves compound interest calculations.

**Conversion:** Preferred stock should convert into common stock automatically at the company’s IPO. The special rights generally accorded to preferred stock sold to early-stage investors could create problems for a public company.

**Anti-dilution** These provisions are designed to protect an investor against “equity” dilution (later sales of stock at a price lower than what the investor paid). Although the “weighted average” version is the most common, an alternative is “full ratchet” anti-dilution protection. Full-ratchet anti-dilution protection is far more advantageous to the investor (but punitive to the company) than weighted average, but it is usually reserved for very early-stage deals or other situations where there is significant concern as to whether the valuation will hold up over the long term. Put simply, weighted-average anti-dilution protection accounts more accurately for the actual dilutive effect which a particular issuance has on the investor’s equity position in the company. Full-ratchet anti-dilution protection, on the other hand, treats all later stock issuances below the investor’s purchase price as if they were the same, regardless of the number of shares issued.

**Voting rights:** Although there are venture capital investors that ask for other *veto* rights, this list covers some of the most frequently requested *veto* rights. You may not have to provide *veto* rights with respect to each of these matters. The key here is to try to limit *veto* rights to major corporate events and to try to avoid turning day-to-day operational matters into matters for a preferred stockholder vote. Thus, for example, (g) and (1) could be problematic if the dollar limits are too low. Often a compromise may be reached with respect to a request for a *veto* right on an operational matter by agreeing that such would be subject to the *veto* of the Series A Preferred Stock’s director but not at the stockholder level. That keeps the issue at the board level -- where it belongs.

**Liquidation:** This is a so-called “straight” liquidation preference. An alternative is the “double dip” or “participating” liquidation preference, which provides that the preferred stock get an amount equal to its money back (plus any accrued dividends if there is an accruing dividend) and then participates with common stock on an “as converted basis." A double-dip liquidation preference is a pricing term most often seen in early-stage deals or in “down rounds."

**Board of Directors:** Working out what the Board will look like following the Series A round will be one of the most important matters to deal with. Generally, the Series A investors will ask for and receive representation on the board. The questions will be how many seats do they get and what effect will that have on the founders’ and management’s board representation. In the end, everybody involved will need to participate in, and be satisfied with, the decisions regarding board structure.

**Options and Vesting:** Venture capital investors will likely impose a vesting schedule on stock and options held by founders, management, and employees as a condition to investment. If shares or options are not yet vested, they are subject to being lost if the person ceases to work for the company for any reason. Venture capital investors impose such vesting requirements in order to provide the company’s people with a reason to stay with the company. Also, if a person ceases to work for the company for any reason, the nonvested shares are available for grant to his or her replacement. The theory here is, of course, that the best business plan is worth nothing without the people to execute it.

**Redemption:** This is simply a right to achieve liquidity in the event that the company does not otherwise reach a sale or IPO by the end of the selected time period. Since the company cannot redeem stock if to do so would render the company insolvent, this right is useful only *in situ*ations in which the company has become some sort of a sideways play. Usually the redemption price is the price paid for the stock plus the accruing dividend, if there is one. Occasionally, venture capital firms will request that the redemption price be at the greater of such price and the then fair market value of the stock. The only thing to watch out for here is to make sure that the company can pay the redemption out over time. (In my experience, three payments over two years are common.)

**Right of First Refusal:** While this is generally asked for and received by venture capital investors (who can give you a yes or no quickly without the need for elaborate disclosure documents to comply with the securities laws), a company should, in my opinion, think about resisting this request if it comes from individual investors.

**Other Provisions:** The term sheet should be non-binding (with the exception only of the exclusivity provision, if there is one, and any provisions regarding confidentiality).

**Expenses:** The amount of expenses included in this provision depends on where the

lawyers are from. Make sure that there is a cap. You may also want to resist any request to pay ongoing fees for the cost of complying with requests for waivers, etc., after the closing (except to the extent to which the investors incur fees because the company breaches its obligations to them).

**Condition to Closing:** Be on the lookout for any exclusivity provisions in this clause. Usually, such exclusivity provisions require the company to refrain from taking an investment from anyone else for a set period of time after the term sheet is signed. While an exclusivity provision may be acceptable (and is often imposed), be sure to pay attention to the time period. It should be no longer than is necessary to complete the transaction, with a little extra time for possible delays. In my opinion, 30 days should be acceptable in most instances; 60 days is pushing it in most instances; and 90 days is probably unreasonable in almost all cases. Also, make sure that the exclusivity period automatically ends in the event that the deal is called off before the period expires.