TERM SHEETS FOR PRIVATE EQUITY INVESTMENTS

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You've received a term sheet from an angel investor or venture capital firm willing to invest much needed growth capital into your company. You may understand most of the business terms of the term sheet, but what about all the other provisions? The following is a summary of some typical terms you might find in a private equity investment term sheet:

<u>Convertible Preferred Stock</u>. The investor usually receives convertible preferred stock for its investment, which is a form of stock with more favorable rights than common stock and which is normally convertible into common stock at anytime.

<u>Dividends</u>. The investor's preferred stock will often accrue a dividend. Since most emerging growth companies lack cash, you should try to get the investor to agree that dividends will only be payable at an exit event or will be paid in shares of stock rather than cash.

<u>Liquidation Preference</u>. The investor will typically require a liquidation preference upon a sale or liquidation of the company. This preference usually equals the amount the investor invested plus unpaid dividends and is paid to the investor before any proceeds of the sale or liquidation are paid to the common shareholders.

<u>Participation Rights</u>. In addition to its liquidation preference, the investor sometimes receives a share of the remaining proceeds of the sale or liquidation that would otherwise go to the common shareholders. You should fight to keep the investor from receiving participation rights. However, if you must give the investor participation rights, you should have the investor's participation rights terminate once it receives an agreed upon return on its investment.

<u>Antidilution Protection</u>. The investor will receive one or more of the following antidilution protections to prevent its investment from being diluted:

(1) First, the investor can be guaranteed a certain percentage of the company. This form of protection makes it very difficult to raise additional money and should rarely be agreed to.

(2) Second, the investor can receive the right to purchase an amount of any new shares the company issues so that the investor can maintain its percentage of the company. This is called a "pre-emptive right".

(3) Finally, the investor can receive "ratchet" protection which allows it to receive free shares in the event of a downround. There are "full-ratchets" and "weighted-average ratchets." The following example shows how the two differ. Assume the founders own 1,000 shares and the company sells 100 shares at $2 per share in its first round and 100 shares for $1 per share in its second round. With a full-ratchet, the investor in the first round receives 100 shares for free. With a weighted-average ratchet, the investor only receives 4 shares. As you can see, with a full-ratchet the investor's effective purchase price always equals the lowest price that the company sells its stock for. With a weighted-average ratchet, however, the effective price is based on a weighted-average formula that takes into account the number of shares outstanding and the price at which the shares were sold for.

Regardless of the form of antidilution protection, the company should be permitted to issue a certain number of shares (e.g., to employees and strategic partners) without the antidilution provisions applying.

<u>Protective Provisions</u>. The investor's consent may be required for the company to do certain things, which is reasonable for certain major events and for transactions exceeding a certain dollar amount.

<u>Registration Rights</u>. The investor may receive demand and piggyback registration rights so that it can sell its shares to the public. With demand registration rights, the investor can require the company to register its shares at anytime. Registering shares is expensive, so demand registration rights should be limited to one or two. With piggyback registration rights, the investor can have its shares registered only if the company registers its own shares. Piggyback registration rights are not as burdensome as demand registration rights since the company will already be registering its own shares.

<u>Drag-Along and Tag-Along Rights</u>. If the majority shareholders desire to sell their shares, then drag-along rights allow them to force the minority shareholders to sell also. Drag-along rights are harsh if the investor is the majority shareholder because the investor can force the sale of the company. Tag-along rights allow the minority shareholders to sell some of their shares if the majority sells some of theirs. Tag-along rights are generally reasonable since the minority shareholders should be able to exit the company if the majority shareholders are exiting.

<u>Board Seats</u>. The investor may require the right to appoint a certain number of members to the board of directors. In general, the number of board members that the investor should have the right to appoint should have some relation to the percentage of the company that the investor owns. For example, if the company has a five person board and the investor owns 20% of the company, then the investor should be limited to appointing one board member. If you agree to

allow the investor to appoint a board member, this right should terminate if the investor's ownership percentage falls below a certain level.

Although you will be anxious to close the deal, don't let your overeagerness cause you to "give away the farm." Believe it or not, you can negotiate reasonable terms if you know what the terms of the term sheet mean and whether they are "industry standard" for a similar transaction. Remember, what you agree to with an investor will affect the terms and chances of subsequent investments in your company.
