Allens > < Linklaters

THE TERM SHEET DECODED

The term sheet will be the key document that determines the basis on which VCs and other investors will invest in your startup. It is critical to get the basics right from the outset.

Entrepreneurs, VCs, bankers, lawyers and bloggers tend to obsess over term sheets and the terms within them. The lingo may seem daunting but it all comes down to two simple concepts:

- **Economics** – the return on investment that the investor will be entitled to on a liquidity event (ie when the company is sold, goes public or goes bust).
- **Control** – the extent to which an investor will be able to exert control over the direction and decisions of the company.

The key to getting your term sheet right is understanding how each term will impact on the economics and control of your startup. Let's take a look at some of the most commonly used terms in each category.

KEY ECONOMIC TERMS

1. VALUATION AND PRICE

How much cash is the investor investing into your startup and how much equity are they taking in return? Valuation is often expressed in terms of: (1) the pre-money valuation, which is the value of your company pre-investment; or (2) the post-money valuation, which is the pre-money valuation plus the intended investment amount. When an investor says that they want to invest $1.5 million for 10% of your company, they are usually referring to the post-money valuation. To figure out the pre-money valuation of your company, you need to calculate the post-money valuation and then subtract the investment amount.

In a $1.5 million for 10% equity investment scenario, the pre-money valuation is $13.5 million and the post-money valuation is $15 million.

Once you've calculated the valuation, you'll need to figure out how many shares your investor gets for their investment. This is usually determined using a capitalisation table. Investors will often take into account holders of warrants and options that may exist in determining the capitalisation to come up with a *fully diluted post-money capitalisation*.

TIP

- The best way to achieve a fair valuation is to present a compelling plan of where your startup is heading and how you intend to use the investment.
- Make sure both you and your investor are on the same page about whether the intended investment amount is based on the pre-money valuation or the post-money valuation.

2. PREFERENCE SHARES

Investors often request preference shares for their investment. Preference shares differ from ordinary shares because of the special rights (preferences) that attach to them.

Common preferences are 'liquidation preferences', which entitle the holder of those shares to recover an additional amount per share (ahead of all ordinary shareholders) in a liquidation event.

A liquidation event may include any sale of the company or its assets, a merger, or a change of control of the company, not merely liquidation upon insolvency.

A typical liquidation preference arrangement may eg involve the distribution of proceeds:

- first, to preference shareholders in an amount equal to 'x' times the amount they invested or pro rata in accordance with their shareholding until each shareholder has received an amount equal to the weighted average of the subscription prices of the preference shareholders for all preference shares held;
- second, to preference shareholders pro rata in accordance with their shareholding until each shareholder has received an amount equal to all accrued but unpaid preference cumulative dividends (if applicable), whether or not declared for all preference shares held; and
- third, to all other shareholders pro rata in accordance with their shareholdings.

Ultimately, however, the size of any additional amount recoverable by preference shareholders and the structure of the mechanism will be negotiated and set out in the term sheet, to reflect the risk inherent in the relevant investment round.

Another common preference is in respect of payment of dividends – ie that a holder of a preference share will be entitled to receive dividends in priority to the holders of ordinary shares.

TIP

- Make sure you understand all the preferences that attach to any preferred share, whether liquidation, dividend or some other right.
- For shares with a liquidation preference, are the preference shares participating? A participating preference share gives the preference shareholder the right to the liquidation preference and to participate with ordinary shareholders in a liquidation event (usually on a pro-rata basis).

3. CONVERSION RIGHTS

Generally, investors holding preference shares will require a right to convert those preference shares into ordinary shares at any time or on certain triggers. IPOs or certain funding rounds are common triggers, as bankers will want companies to go public with a single class of shares (in the case of an IPO) or investors may want to share in the upside of an increased valuation on a funding round.

TIP

Make sure that the triggers for conversion are consistent across the different classes of preference shares that are issued. This will minimise the opportunity for preference shareholders with higher trigger points to hold out in the event of an IPO below that trigger.

4. ANTI-DILUTION

Anti-dilution mechanisms are used by investors to protect the value of their shares from being diluted in the event of a subsequent capital raising at a lower valuation, otherwise known as a down-round. There are two main types of anti-dilution arrangements:

(1) full-ratchet anti-dilution, which adjusts the investor's share price all the way down to the share price of the new round; and

(2) weighted average anti-dilution, which adjusts the investor's share price only part of the way down to the share price and takes into account the number of shares or rights issued at the reduced price, not just the actual valuation. Weighted average anti-dilution mechanisms are either narrow or broad, depending on whether the weighting takes into account all equity previously issued and currently under issue (broad), or only the total outstanding preferred shares (narrow), when determining the new weighted average price for the old shares.

In an ideal scenario, you'll avoid anti-dilution provisions altogether. This might be acceptable to investors in seed rounds when the valuation is reasonably low. But if you can't, your next best bet is to apply a broad-based weighted average formula designed to balance the impact of the new share issue on the value of existing shares.

TIP

- Avoid full-ratchet anti-dilution provisions – if your investor insists on an anti-dilution provision, opt for a weighted average anti-dilution mechanism.
- Consider whether any carve-outs to your anti-dilution provision might be appropriate.
- Be wary of anti-dilution calculations tied to revenue, product development or other milestones that the investors have set for your startup, resulting in a conversion price adjustment where you fail to meet those milestones.

5. PARTICIPATION OR PAY-TO-PLAY

Pay-to-play provisions are designed to ensure that investors are prepared to come along for the ride by forcing participation in later fundraising rounds. A typical pay-to-play term will require that all holders of preference shares participate in future fundraising rounds, with non-participation resulting in the automatic conversion of their preference shares into ordinary shares.

TIP

While pay-to-play provisions are generally good for founders, pay-to-play provisions that force a full recapitalisation of the company are bad for everyone. Remember, you might have certain unsophisticated angel investors who will not have the resources to make ongoing future investments. Stick to a mechanism that results in conversion of preference shares into ordinary ones.

6. PRE-EMPTION RIGHTS ON FUTURE SERIES FUNDRAISING ROUNDS

It is common for investors to request a right of first offer to purchase up to its pro rata share of any further share offering by the company. Investors may also request a right of first refusal, so that any ordinary shareholder who proposes to sell their shares to a third party must first offer them to the Series A investor.

KEY CONTROL TERMS

1. RIGHTS TO APPOINT DIRECTORS

Typically, investors will require a right to appoint a director to the board. Your constitution and shareholders' agreement should set out the powers and structure of the board. It is important that you understand the power and influence that your new investors will have. It is standard practice for investor-appointed directors to acquire veto rights over some decisions, particularly if the investor does not have board control.

TIP

An effective board can be critical to the success of your startup. Try to keep it balanced and in proportion to the size of your startup. An independent board member (not related to the founders or the investors) can be an effective way of ensuring deadlocks can be broken in an impartial manner, keeping the startup's best interests at heart.

2. DECISION-MAKING – BOARD VS SHAREHOLDERS

It is important to agree upfront the manner in which decisions about the business of your startup are to be made – this includes who should make the decision (ie the board or the shareholders) and any other conditions to be satisfied or consents required in order for that decision to be effective.

For example, the board may have the power to make decisions regarding the employment of new employees (which may then be delegated eg to the management team), whereas decisions regarding executive remuneration, or acquisitions / disposals above a threshold amount, may be reserved for shareholders. Reserving certain decisions for shareholders limits the board's power by adding an additional layer of oversight. Note also that certain decisions of shareholders can be made by way of ordinary resolution (50% of votes), whereas other more significant decisions may require a special resolution (at least 75% of votes).

Being clear about the framework for decision-making, particularly in the context of negotiating investment, is a useful way of ensuring that both founders and investors are on the same page as to how the company will be run going forward.

TIP

Generally, decisions relating to the future of the company should be made by shareholders, whereas decisions regarding the day-to-day operation of the company should be made by the board.

3. TAG AND DRAG

Tag rights protect the rights of minority shareholders in the event that a majority shareholder sells a certain threshold number of their shares. The tag right requires that the minority shareholders may elect to participate in the sale of shares on the same terms as the selling majority shareholder.

Drag rights are the reverse, giving majority shareholders protection from minority holdouts in the event of an offer to purchase the majority shareholders' shares. A typical drag right will enable the majority shareholder to require each minority shareholder to participate in the sale event so long as they are afforded the same terms as the majority shareholder.

TIP

Tag and drag rights are common in VC-backed startups. Make sure you are familiar and comfortable with the thresholds that apply.

OTHER KEY POINTS TO CONSIDER

- FOUNDERS' RIGHTS AND RESTRICTIONS – Investors will often be keen to ensure startup founders are focused solely on their investment and will stick around to drive the success of the startup. Key mechanisms you might find in term sheets are:
  - VESTING – In a typical vesting arrangement, shares for founders are not issued in one hit. Rather, they vest with the founders over a number of tranches tied either to performance or chronological (in terms of employment or engagement with the startup) milestones. Usual time periods are four years with a 12-month cliff (meaning 25% after one year) and monthly vesting thereafter. Make sure vesting criteria is objective and easily measurable, to prevent disputes as to whether the criteria has been achieved.
  - FOUNDERS' ACTIVITIES – It is not uncommon for a clause to be included requiring a founder to commit 100% of their professional energies toward the startup in question. We would hope this is the case in any event!
- WHAT HAPPENS AFTER INVESTMENT? The terms you accept in your term sheet should be driven in large part by what you want from your investors. Are you looking for active investors that will be a partner for growth and will assist in the day-to-day decisions of your startup? If so, then you might be more open to greater control and economic rights for that investor.

  Is your investor more passive? Do you have a clear plan for the investment they are providing and the growth path of your company? In this case, it might be best for all parties if control is left to you and your startup team.

  It is critical to think about what comes next. If you are in the early stages of your startup and your term sheet relates to early-stage funding, you need to be especially careful that the rights attaching to your investors' shares won't make your startup an unattractive target for later-stage investment. To avoid this, ensure that your investors' interests align with your own and that they are willing to come along for the ride.

Allens > < Linklaters

INTRODUCING THE A-SUITE

We know that legal issues are the last thing you want to focus on at the early stages of your startup venture. That's why we've developed a set of high-quality legal solutions specific to startups – called the A-Suite – to help you get your company up and running without a significant outlay of time or money.

The A-Suite is being made available on a free and open access basis to startups.

www.allens.com.au/accelerate

ALLENS ACCELERATE

Allens Accelerate is a legal practice dedicated to supporting the Australian startup community and providing expert legal advice to startups, investors, and corporates and government agencies responding to disruption and investing in innovation. Contact our team for more information.

CO-PRACTICE LEADERS, ALLENS ACCELERATE

Gavin Smith
Partner
T +61 2 9230 4891
M +61 428 254 219
Gavin.Smith@allens.com.au
@GSmith_Allens

Valeska Bloch
Partner
T +61 2 9230 4030
M +61 409 031 622
Valeska.Bloch@allens.com.au
@valeskabloch

KEY CONTACTS

Mark Malinas
Partner
T +61 3 9613 8485
M +61 409 389 789
Mark.Malinas@allens.com.au

Elyse Adams
Managing Associate
T +61 3 9613 8534
M +61 404 942 379
Elyse.Adams@allens.com.au

Dominic Anderson
Senior Associate
T +61 2 9230 4099
M +61 451 237 801
Dominic.Anderson@allens.com.au

Helen Dolling
Senior Associate
T +61 8 9488 3743
M +61 400 231 376
Helen.Dolling@allens.com.au

Join the conversation on Twitter

#AllensAccelerate