VENTURE CAPITAL
DEAL TERMS

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A GUIDE TO NEGOTIATING
AND STRUCTURING
VENTURE CAPITAL TRANSACTIONS

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Sjoerd Mol is an attorney-at-law and partner at Benvalor law firm based in Utrecht, The Netherlands. Sjoerd specialises in mergers & acquisitions and venture capital. His clients include investment funds, business angels and start-ups. Sjoerd is co-founder of www.capitalwaters.nl, an internet platform for early-stage deal documentation, and is active as mentor and legal partner of several start-up accelerator programmes. Sjoerd holds both a masters degree in law and a masters degree in economics from the University of Utrecht.

PREFACE

In 2004, a famous Dutch Professor, whose company we were spinning out of the university, asked me to explain to him exactly what I was asking him to sign. Before him was a term sheet that I had drafted. Because I didn't have a lot of time, I promised him that I would provide him with a written explanation of the most important terms. That's how the idea of writing this book was born. I started writing immediately. However, combining a full-time job with writing a book took more time and effort than I expected, so after five months of scribbling during nights and weekends, I asked my good friend, Menno van Loon, to help me out. Menno and I did the bar exam together, many years before. His experience as a lawyer and later as an investment banker, came in handy. Together we finished the book in twelve months' time and published it with Reed Business Information in 2005, under the title "Venture Capital Term Sheets. How to structure and negotiate venture capital transactions."

Since then a lot has happened. I started new funds and invested in many high-tech companies. The banking crisis came and went and so did many venture firms. Niche law firms emerged, focusing solely on venture transactions. Sjoerd Mol, a partner at one such law firm, suggested to me and Menno that our book was getting outdated and needed adjustment. The three of us set out to update and rewrite the book. We made the book more complete and many of the clauses easier to understand, since we also explained the economics behind the terms. We also added tips and suggestions both for the entrepreneur and the investor. By doing this, we genuinely believe that we have created a level playing field for all stakeholders involved in any venture capital transaction.

For ease of reading we have used male pronouns (he/his/him) throughout the book as a generic pronoun for both genders.

We could not have succeeded in creating this end product without the help of our friends. Also on behalf of Menno and Sjoerd, I would like to especially thank Marlon Dijkshoorn, who helped us with the fine tuning of the financial paragraphs, and Pieter Jan Dorhout, who once again proofread the entire manuscript and changed many phrases into impeccable English. Finally, I would like to thank my sister, Gaby de Vries, for making (again) a beautiful cover for the book.

Harm de Vries

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1 INTRODUCTION

Venture capital has established itself as an important source of capital for a variety of companies, ranging from start-ups to more established businesses. Consequently, the number of people who are at some point in their career involved in a venture capital transaction, is steadily increasing. While some people involved in venture capital transactions have extensive experience in this area, the knowledge of others is at best rudimentary. Entrepreneurs in whose company a venture capitalist will invest, lawyers working in this field for the first time, and even junior venture capitalists and angel investors often lack the full understanding of all aspects of venture capital financing required to ensure a successful transaction.

The purpose of this book is to provide a clear understanding of the most frequently used practices, terms and conditions to those with less than extensive experience in venture capital transactions. We believe, however, that this book will also serve as a valuable reference guide for the more experienced venture capitalist.

Practically all venture capital transactions start out with the execution of a term sheet. A term sheet is a document summarising the basic terms and conditions under which investors are prepared to make an investment. It also sets out the structure of the transaction, the parties involved, the timelines for due diligence and the deadline for the closing. A well-drafted term sheet serves as a tool to focus attention of the parties on the essential elements of the investment, and as an instrument to investigate whether there is common ground between the parties regarding the most important investment conditions, before they spend further time, energy and money on negotiating a deal. A term sheet covers the main aspects of a venture capital financing and facilitates the execution of the final transaction documentation.

Effective participation in the negotiations regarding the term sheet is possible only once each party involved fully understands the scope of the terms included in the term sheet (including the commercial implications thereof) and the information it contains, and the alternatives to the terms in use. Moreover, a clear understanding of such terms is likely to expedite the negotiation of the term sheet and completion of the investment process. We hope this book will be of assistance in gaining such an understanding, to the benefit of all parties concerned.

1.1 STRUCTURE OF THE BOOK

This book is intended to be a practical and easy-to-use guide. In section 2 of this chapter, we will first discuss the investment process in general. In chapter 2, a fictional venture capital transaction will be used as the basis for the discussion of the different clauses most commonly used in term sheets. Chapter 3 contains the term sheet that will be submitted to the company trying to raise an investment round in the transaction described in chapter 2. This term sheet will serve as the base for the rest of this book, wherein each subsequent chapter will deal with specific subjects dealt with in the term sheet (e.g. liquidation preference, anti-dilution protection, drag along, and tag along). Each chapter discussing a certain type of clause in the term sheet will include a standard version of such a clause and, if applicable, alternatives to the same, for easy reference. A glossary of terms commonly used in venture capital transactions is attached as Annex 3 of this book.

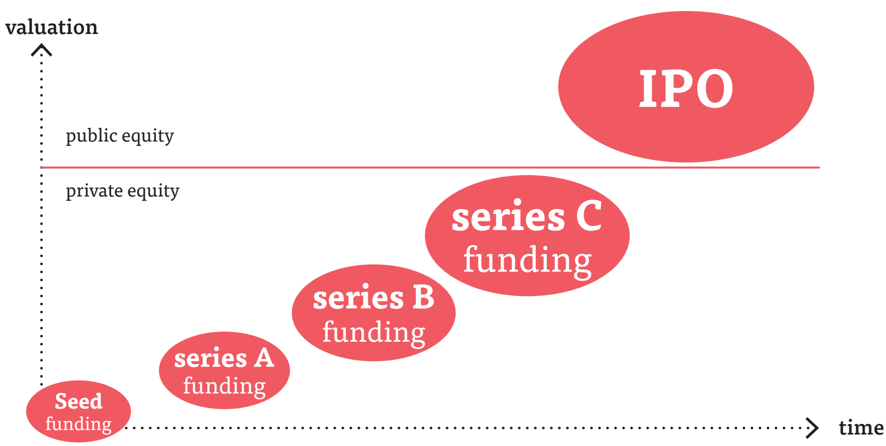
1.2 INVESTMENT PROCESS

Venture capital firms invest in companies with high growth prospects, enabling them to earn their return upon an *exit* by selling their shareholding of those companies to another company (trade sale) or to the public (in an *initial public offering* or IPO). Venture capital firms usually look to retain their investment for a period of at least three to seven years. This period often depends on the stage the company is in, its growth profile and the opportunity to realise an exit. The stages a venture-backed company will go through in chronological order are generally referred to as the *Seed*, *Early* and *Growth*.

The chance that a company will fail to realise its business plans within the set time frame is considerable. In order to limit their financial risk, venture capital firms invest in companies in multiple rounds, rather than providing the total investment required from the start. Staging the capital contributions through different investment rounds allows investors to assess the company's progress in terms of value increase prior to each new investment round and enables them to take timely measures if the viability of the company is at stake. It also offers several opportunities to minimise losses by discontinuing the project. If the value of the company increases, multiple rounds make it possible to issue equity at a higher price in each round, thus enabling the shareholders to capitalise on the progress they have achieved between consecutive rounds.

The time between rounds depends on the time required for the company to achieve value- increasing *milestones* (see *section 3 – Milestones*, of chapter 4) and typically ranges from 1 to 2 years. Over time, the burn rate (rate at which the company uses up its available funds) of the company tends to increase, meaning that more money will be required to bridge an additional period of similar length. Consequently, since the investment risks generally decrease as the company moves into a more mature phase, larger amounts are usually committed in later rounds.

FIGURE 1: VENTURE CAPITAL INVESTMENTS



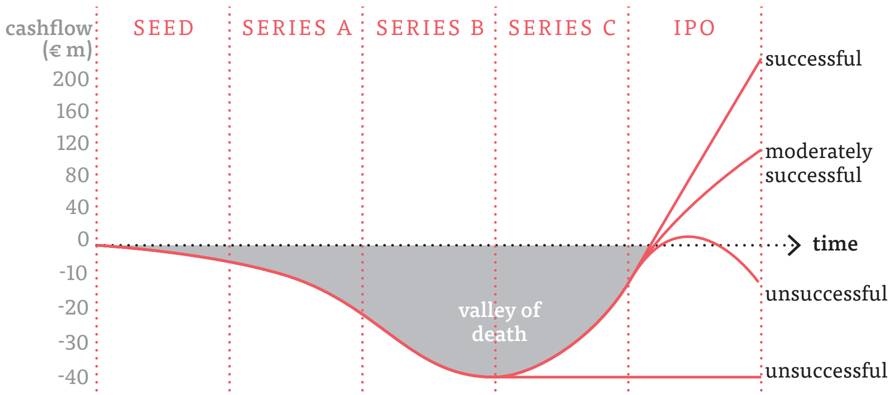
Investors investing in each round of financing will negotiate investment terms reflecting the specific investment risks they perceive. Typically, they will not accept terms that are less favourable than the terms negotiated in earlier rounds. Most of the rights negotiated in a financing are attached to the *(preferred)* shares issued in that specific round. To distinguish between these different rights, each round will typically have its own series *(class)* of shares, starting with Seed funding, followed by the Series A investment round and after that as many other rounds as are necessary until an IPO or acquisition of the company takes place.

In practice, the investment process can be a time-consuming and costly affair. Legal costs can (and usually do) form a large part of the costs involved in that process. More often than not, the legal costs will be higher than anticipated. The best way to avoid excessive legal costs is by being well prepared. Only involve a lawyer in matters where he truly has an added value. Take your time in selecting a good lawyer with solid experience in venture capital transactions (you don't want to pay a lawyer for providing him with an on-the-job venture capital learning experience).

If you are planning on doing a venture capital transaction in a country in which you have not been active before, it is important to ensure support from knowledgeable advisors. Not doing so could result in costly misunderstandings due to (for example legal) differences between the country you are used to working in and the "new" country.

The time required to raise money differs from case to case, but generally speaking the whole process, from the first cup of coffee with the venture capitalist to closing of the transaction, will take four to eight months. Venture capital investors usually want to assess a company's performance over a certain period of time, rather than base their investment decision on the company's performance at one moment only. So the advice to start-ups is: start drinking cups of coffee with venture capital investors as soon as possible. Since the time between financing rounds is usually no more than one or two years, as set out above, investor interaction should basically be a continuous activity for any start-up's CEO.

FIGURE 2: LIFE CYCLE OF START-UP



This is what venture capital is all about: the financing of loss-making companies to help them through the equity gap (also called: 'valley of death'). The equity gap arises from the perception that high risk, high transactional and monitoring costs, and the long development trajectories associated with early-stage ventures make them unattractive for investment. Due to this perception, most investors favour ventures in later stages of development that can demonstrate marketing and financial history. Venture capital investors, however, have a different perspective. They believe the risk involved in early stage investment is acceptable in view of the potentially high returns that can be realized if a start-up company becomes successful.