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CAPITAL TRENDS

TERM SHEETS PLAY PIVOTAL ROLE IN FINANCING FOR TECH VENTURES

At some point in its development, almost every startup company faces challenges related to financing. For early-stage, high-tech ventures, where the timeline to significant return on investors' capital is often lengthy, the challenges can be even greater.

With few exceptions, all of those challenges are tied up with a financing package's term sheet, says Anthony Pergola, vice chair of the Tech Group at Lowenstein Sandler, a leading East Coast law firm with more than 100 attorneys focused on corporate deals. The firm's 40+-person Tech Group guides IT, software, communications, life sciences and other technology-driven companies in venture capital, angel financing, M&A and public offering transactions, as well as all patent, licensing and other intellectual property needs.

TERM SHEET STAGE IS WHERE COMPETITION PLAYS OUT

"All of the terms that count – both financial and legal – are covered in one way or another in the term sheet, so term sheets play a crucial role in the process," Pergola says. "When you are good enough, or lucky enough, to have more than one venture firm interested in your company, it is at the term sheet stage that competition really plays out – in valuation and in terms, such as whether the founders can take some money off the table or whether an investor's preferential return is somehow capped. Of course, picking the right partner is critical – and you can learn a lot about your financial partner by paying attention to how he/she negotiates the term sheet."

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The term sheet stage is one of the key places where experienced, savvy venture counsel can add real value, so it is important to seek help before this stage is complete, Pergola advises. "Most entrepreneurs go through the venture process only a few times in their lives, but investors live with these term sheets every day," he warns. "Seasoned counsel can bridge that knowledge imbalance and help guide entrepreneurs, not only with identifying legal risks, but also with what terms and conditions are acceptable in today's private capital markets."

VENTURE CAPITALISTS FOCUS ON ECONOMICS AND INFLUENCE

Generally speaking, venture capitalists are interested in just two things: economics and influence. Economics refers to the ultimate return they will get on their investment and the terms that will affect that return. Influence is about the mechanisms and strictures, such as board seats and veto rights, that guide decisions made by the company's principals.

Term sheets can be expansive documents, and their content may be influenced by the type of venture being funded and/or the nature of the financing being provided. Examples of sections commonly found in term sheets include:

- valuation and pricing
- liquidation preference
- composition of board of directors

- protective provisions (veto rights)
- drag along (right of majority of holders to force a sale or liquidation)
- conversion
- anti-dilution
- dividends
- redemption rights
- information rights
- registration rights
- right of first refusal
- voting rights
- restriction on sales of stock by founders

“Although there is plenty to negotiate after the term sheet stage, the majority of the vital economic terms and many of the important legal issues are hammered out at this juncture,” Pergola says. “This is where the entrepreneur and the lead investor are most directly engaged with one another, dealing with issues at the business level. After the term sheet stage, much is left for lawyer-to-lawyer discussions.”

TAKE ADVANTAGE OF EXPERT HELP IN NEGOTIATING TERM SHEETS

As in any type of negotiation, both parties to a term sheet discussion seek to secure the most advantageous position possible. For early-stage tech companies, it is particularly important to seek all the help they can, Pergola says.

“Don’t go it alone,” he stresses. “Make sure that your financial advisors and your lawyers are involved in helping you with the term sheet negotiations. If you don’t understand something, make sure you ask. Understand that there is a connection between valuation and terms; when there is a difference between the company’s expectation for pre-investment valuation and the investors’ expectations, there are creative ways to bridge valuation gaps.”

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