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All you need to know about negotiating a Venture Capital Term Sheet

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The venture capital funding is more than $288 billion worldwide in just half of 2021. This was $110 billion in the year half of 2020.[1] The records from Crunchbase show that there has been an increase of 61% in venture capital funding as compared to the second half of the previous year.[2] With the increase in venture capital funding, it becomes important to how to go ahead with the negotiation process for the successful transaction. This article will primarily focus on the term sheets and what are the clauses that can be negotiated. The main objective behind this research paper is to bring out various clauses that are used in the venture capital term sheet. The paper will focus on the terminology and the uses of the clauses and at what point they can be negotiated. This article is an attempt to explain the negotiation of the venture capital term sheet.

Keywords: *voting rights, tag-along, right to the first refusal, weighted-average method, full ratchet method,*

[1] Gene Teare, 'Global Venture Funding Hits All-Time High In First Half Of 2021, With $288B Invested' (*Crunch Base*, 7 July 2021) <https://news.crunchbase.com/news/global-vc-funding-h1-2021-monthly-recap/> accessed 07 October 2021

[2] *Ibid*

INTRODUCTION

Raising the first round of investment by venture capital is one of the most significant events of the start-up. The start-up companies survive till here by pre-seed funding or bootstrapping and various other rounds of seed funding. These rounds of funding are much simpler when compared with the venture capital rounds of funding. With the change of investors, complexity in agreements and their negotiation occur. Complexity arises in shareholder's rights, exit rights, rights of the board of directors, anti-dilution rights, indemnity, etc. And to simplify the agreement negotiation is made earlier. And thus the "term sheet" plays the role of a key document in a venture capital transaction. Preparation and negotiation of a term sheet can solidify the transaction and helps in creating momentum between the parties involved.[3] If initially, a term sheet is well-drafted this can minimize the time of drafting the final agreement. And if you are wondering, whether each term in the venture capital term sheet can be negotiated or not? The answer is YES all the terms are negotiable. Let's go ahead and read about what is a term sheet and various clauses that can be negotiated in it.[4]

WHAT IS A TERM SHEET?

A term sheet is a "non-binding" document except confidentiality, exclusivity clause, or whichever clause is kept binding in it. It contains principal terms and conditions that are necessary to the transaction in the form of a bulleted list. The term sheet can be negotiated further before entering into a final agreement.

Given below are clauses that can be found in almost every venture capital term sheet and could be negotiated as per the transactions:

- **Pre-emptive Rights:**

[3] Morgan Lewis, 'Preparing a venture capital term sheet' (Morgan Lewis, 2020) <https://www.morganlewis.com/-/media/files/supplemental/2020/preparing-a-venture-capital-term-sheet.pdf > accessed 7 October 2021

[4] *Ibid*

Pre-emptive Rights are also known as pro-rata rights. This right is given to the investors and shareholders so that if they want, they can maintain their ownership percentage in the company after the subsequent financing rounds. When this right is given to the investors and the company proposes to issue additional shares, the company will be having an obligation to offer the shares to the investors who will be having the pre-emptive rights. The investors will be having an option (instead of an obligation) to purchase those shares or not.

Section 62 of *the Companies Act, 2013,*[5] provides pre-emptive rights to the shareholders of the public companies by default unless they by special resolution of shareholders obtain to exclude their rights for specified issuance. An exemption has been provided to the private companies in this regard.[6]

- **Rights of Board of Directors:**

The investors can ask the founder for a "board seat" for itself, which can give the investors the right to appoint a non-executive director and for reconstituting the Board of the investee company. The director appointed from the investor's side does not usually involve in the day-to-day activity of the company. Their task is to stay informed about what's going in the company. Sometimes, the board can have an observer. He doesn't have any voting rights but he is to make sure that no irregularity is being done in conducting meetings and rights of members are not restricted beyond the articles of association of the company.

Investors will negotiate for the "*affirmative voting rights*". Affirmative voting rights are the voting rights with respect to the "reserved matter". They are the key issues in the business other than the ordinary issues in the business. Investors usually require the company to provide them with periodic information on the company's performance. Such as cash flow statements, balance sheets, projected budgets, business plans, etc. If there is any deviation

[5] Companies Act 2013, s 62
[6] 'Exemption to Private Companies' (*Ministry of Corporate Affairs*, 2021) <https://www.mca.gov.in/Ministry/pdf/Exemptions_to_private_companies_05062015.pdf > accessed 07 October 2021

from the plan the investors may demand an explanation in writing. The investors have the right to inspect the account books of the company.[7]

- **Transfer Restrictions/ Lock-in period for founders:**

The lock-in period assures the investors that the founders are interested in the business of the company. The lock-in or transfer restriction clause restricts the founders of the company from transferring, selling, assigning, or pledging their shares for a specified period of time. The duration of the lock-in period is a matter of negotiation between the parties to the agreement. Investors usually restrict founders from selling their shares till the time the investors exit from the company.

Founders of the company should try to negotiate for the ability to sell the shares partially (if they continue to maintain a majority stake in the company) after the mandatory period of lock-in say one to three years. This helps the founders to maintain the cash flow in the company.

- **Indemnity:**

While entering into an agreement, the company and the promoters provide representations and warranties for certain business-related things.[8] The breach of one or more of the representations and warranties gives rise to indemnity. Once any breach happens, the investor can seek indemnification from the indemnifying party.[9]

The cap or threshold for the monetary payment and time limitations can be negotiated between the parties to the contract. Usually, investors impose the obligation of indemnification on both the company and the founders or promoters. This can be a risk for the founders as their personal assets will be at stake. So, the founders of the company should try to restrict it to the company only since the investment is being made for the benefit of the company.

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[7] *Ibid*

[8] *Ibid*

[9] Siddharth Raja and others, 'Negotiating Term Sheets: When to "Yes!" & How to Prepare for the Future ' (*Argus Partners*, 2017) <https://www.argus-p.com/uploads/blog_article/download/1519630371_Negotiating_Term_Sheets_When_to_Say_Yes!__How_to_Prepare_for_the_Future___.pdf > accessed 07 October 2021

- **Exit Rights:**

Exit may be provided to the investors on occurring of any trigger event or at the end of the time period agreed for exiting the company. Investors mostly try to retain *drag along right* with them. It can allow the majority shareholders to drag the minority shareholders to sell their shares in the event of any breach. The right to drag along generally gets terminated upon an initial public offering of the company.[10]

There is another clause that protects the rights of the minority shareholders when the majority shareholders want to take exit from the company either partially or wholly this clause is called *tag-along*. Investors may also ask for the *right to first refusal* (ROFR). This clause ensures that the investor will be the first one to have the right to purchase the stake of the founders if the founder wants the exit (founders are allowed to exit when the lock-in period is over or when the investors give their consent for it). Shareholders then can sell their shares to the third party only when the existing shareholders of the company refuse to buy them on the same terms.

- **Liquidation Preference:**

Venture capital while investing in the early stages of companies requires a premium on the money they invested. This preference gives the investor the right to receive a return before any other investor on liquidation or sale of the company. These are usually in the multiple of the original investment made. The clause of liquidation preferences prevents the venture capitalists from making the loss by making sure that they get the amount of investment done in preference before other investors.

Liquidation does not only mean winding up of the company but includes events like mergers, issuing of shares beyond a specified limit, change in the control of the company, etc. Investors not only seek the investment amount but usually, they seek a specified internal rate of return. This is subject to certain limitations specified in the *Companies Act, 2013 (Section 326[11] – 327[12]*)

[10] *Ibid*
[11] Companies Act 2013, s 326
[12] Companies Act 2013, s 327

read with *Section 255* of *the Insolvency and Bankruptcy Code, 2016.*[13] The internal rate of return is subject to limitations as per the above-mentioned sections. Thus, workmen's dues, secured creditors, government dues salaries, social security contributions, unsecured lenders, debenture holders, preference shareholders, and equity shareholders get priority over the internal rate of return. This clause will be valid only when it abides with the laws and regulations.[14]

While negotiating the investee company and its advisor should agree with the liquidation preference clause only after carefully going through it. So, that definition of "liquidation events" can be narrowed down especially in the case where the internal rate of interest is high.

- **Non-Competition:**

Founders are usually restricted from engaging themselves in other businesses of any kind so that they can concentrate on the company by their full potential. A non-compete clause restricts the founders from doing any business within the investment horizon and prohibits them from pursuing the same for the particular period of time as specified in the contract after the exit of the founders from the company or after the termination of their employment.

In the case of founders, unlike an ordinary contract, a non-compete clause will be applicable even if they are not full-time employees of the company. It will apply to them till the time they will be having the shares of the company.

- Founders can negotiate that they will be continuing to keep a stake in the businesses (those do not compete with the business to the investee) they were doing before, till the time they are able to give time to the business involved.

Usually, a competing business is defined very broadly and is unclear. Founders should try to negotiate for narrowing down the definition of a competing business.[15]

[13] Insolvency and Bankruptcy Code 2016, s 255
[14] *Ibid*
[15] *Ibid*

- **Anti-dilution Rights**

Anti-dilution rights give protection to an investment from being diluted or getting less valuable. This clause protects the interest of investors if the valuation of the investee company decreases in the subsequent funding rounds, known as ***"down-round"***.

When the Investor purchases the securities of the company that can be converted then the condition upon which the securities will get converted can be negotiated, conversion ratio can be discussed. This becomes tough in the case of equity shares as the company will have to issue fresh shares to the investors and as per *Section 53 of the Companies Act, 2013*[16] company cannot issue shares at a discount or free without the prior approval of the Central Government. The standard way to implement this clause is by following the "*weighted-average method*" instead of the "*full ratchet method*".[17]

EFFECT OF ANTI-DILUTION CLAUSE IN CASE OF REDBUS

The valuation of the company does not always increase in the subsequent round of funding. And the same happened with the Redbus. In the case of Redbus, the investors had the *full-ratchet* clause to prevent their shareholding in case of the dilution of the company. Thus, when the founders of Redbus took an exit from the company they had less than a 15% stake in it.

- **Pay-to-play provision**

The "*Pay-to-play*" provision requires the existing investors in the company to invest in the future subsequent rounds of funding on a pro-rata basis or they lose some or all the preferential rights. There are two ways by which this provision works:

1. By automatic conversion into a "shadow" series of preferred stock; or

[16] Companies Act 2013, s 53
[17] *Ibid*

2. By automatic conversion into a common stock, results in the loss of all the preferential rights investors had known as "strongman" pay-to-play.[18]

The pay-to-play provision can have an impact on the economics of the deal transaction since it reduces the liquidation preferences of the non-participating investors. It's a way of minimizing the negative impact of the anti-dilution clause for later investors.[19]

Dispute Resolution or mediation

A mediation or dispute resolution clause plays a very important role when any issue or dispute arises between the parties to the contract. Usually, while negotiating for the venture capital term sheet parties fix the period during which they can resolve the issues that have arisen but when these issues don't get resolved they have the option of arbitration. Founders should try to negotiate for the arbitration seat in India (a city that is convenient for them) if investors are non-resident of India.

CONCLUSION

We can conclude that negotiation for the term sheet differs from transaction to transaction. Negotiating a term sheet of venture capital is an adjustment between the parties for deciding the contractual rights and obligations for the investment transaction. A well-negotiated and detailed term sheet can help to lead a successful investment transaction. The key players are the investors and the founders of the company. Thus, negotiation between them for the rights and obligations on each other to achieve the purpose of the transaction for the present as well as for the future is the aim of negotiation of the term sheet.

[18] Scott Edward Walker, 'Demystifying the VC term sheet: Pay-to-play provisions' (*VentureBeat*, 9 May 2011) <https://venturebeat.com/2011/05/09/demystifying-the-vc-term-sheet-pay-to-play-provisions/> accessed 06 October 2021

[19] *Ibid*