# Term Sheets 101

## What You Need to Know When Negotiating Venture Capital Financings

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## Introduction

Raising capital is an important endeavour for growing businesses. For start-ups that may have already completed "pre-seed" and "seed" financing rounds with founders, family, friends, and smaller investors, the next step is often to raise capital from venture capital ("**VC**") investors. Typically, these financings begin with a VC firm providing a term sheet to the company, summarizing the key terms of the proposed investment. The term sheet is negotiated, and once finalized and signed, the parties have an outline of the key deal terms that will form the basis for the longer "definitive" documents to be signed at closing when the VC's investment funds are advanced to the company.

The negotiation of the term sheet is therefore very important, as it will house the key deal terms and form the foundation for the investment. However, founders often face a disadvantage when negotiating term sheets with VC investors. For many founders, it may be the first time they have ever seen a term sheet, whereas sophisticated VC investors will likely have negotiated dozens of them over their careers. This experience imbalance makes it all the more important for founders to understand term sheets before they find themselves in negotiations, and to make sure they engage knowledgeable counsel to help protect their interests.

In this guide, we outline some key aspects of term sheets that founders should understand, and some tips to successfully negotiate a term sheet with a VC investor. For the purposes of this guide, we have assumed that the VC investor proposes to purchase preferred shares of the company (which is a typical investment structure for a company's first financing following a seed financing round).

Additionally, for Canadian start-ups and VC firms alike, a great resource is the Canadian Venture Capital and Private Equity Association ("**CVCA**"), which has a free resource library including a sample VC term sheet for preferred shares. This guide highlights many of the key provisions included in the CVCA sample term sheet.

This guide is written as a follow up to a presentation made by Rebecca Cochrane at the Canadian Fintech Summit presented by Framework Venture Partners, BDC Capital and MaRS Discovery District in March 2021.

## 1. Company Valuation

One of the most important topics in a term sheet negotiation is determining the value of the company in which the VC proposes to invest. There are three main valuation concepts founders should be familiar with in order to fully understand a valuation proposed in a term sheet: "fully diluted equity", "pre-money" valuation and "post-money" valuation.

If a valuation assumes "fully diluted" equity, it means that it accounts for all the current outstanding shares of the company, and for all potential shares that could be issued in the future based on current expectations. This would include any shares issuable upon the exercise of outstanding warrants and the conversion of outstanding convertible debt or SAFEs (simple agreements for future equity). A fully diluted calculation normally also assumes the full deployment of a company's stock option plan, if any. For example, if a company's stock option plan allows for the issuance of shares equal to an additional 20% of the outstanding shares of the company, a fully diluted valuation will assume that all of those shares are issued *prior* to the VC investment. Therefore, a "fully diluted" equity valuation, as opposed to "non-diluted," will serve to dilute the existing shareholders of the company rather than the VC investor. Therefore, it is important to understand which assumption is being used when looking at a proposed valuation.

The remaining concepts to consider are "pre-money" and "post-money" valuations. As the names suggest, a pre-money valuation values the company before the VC investment is made, while a post-money valuation values the company after the VC investment. Typically, VC investors and term sheets refer to a post-money valuation. As with fully diluted equity, it is important to understand what assumptions underlie a valuation, and whether it is a pre-money or post-money valuation.

The table below outlines the difference between these concepts, based on a scenario where a VC firm proposes to invest $500,000 based on a $1,000,000 company valuation.

| | Pre-Money | | Post-Money | |
|---|---|---|---|---|
| **Founders** | $1,000,000 | **67%** | $500,000 | **50%** |
| **Investor** | $500,000 | **33%** | $500,000 | **50%** |
| **Total** | $1,500,000 | | $1,000,000 | |

If the $1,000,000 valuation refers to a pre-money valuation, as shown in the pre-money column of the above table, the founder will retain two-thirds of the company's shares after the investment. However, if the $1,000,000 valuation refers to a post-money valuation, as shown in the post-money column of the above table, the founders will only hold half of the company's shares post-investment.

## 2. Other Economic Terms of VC Investments

Beyond the pure percentage of shares a VC investor will hold post-investment, there are other economic terms that are negotiable in a term sheet. The three most commonly negotiated economic terms when a VC invests in preferred shares are liquidation preferences, dividends and conversion rights.

### *Liquidation Preferences*

A liquidation preference (also known as a "preferred return") for preferred shares represents an amount the company must return its preferred shareholders before payments can be made to other shareholders. A liquidation preference is triggered in the context of certain "exit" or liquidation events, such as a sale of or winding-up of the company, a merger or amalgamation with another company, or the sale or lease of all or substantially all of the company's assets. A liquidation preference is usually expressed as a multiple on an original investment – e.g., a 1x, 1.5x or 2x liquidation preference.

Liquidation preferences are sought by VC investors in order to protect their investments from downside risk. It provides the investor the best chance of recouping their investment (and potentially more) by guaranteeing priority of funds paid out of a company.

It is imperative for start-ups to understand the implications of liquidation preferences in exit scenarios, particularly if a VC has negotiated a liquidation preference greater than 1x its original investment. The table below outlines the implications of a 2x liquidation preference, assuming a scenario where a VC firm has invested $500,000 in a company based on a $2,000,000 post-money valuation, and the company is ultimately sold for $3,000,000.

| | Post-Investment | | Exit Proceeds | |
|---|---|---|---|---|
| **Investor Preferred Shares** | $500,000 | **25%** | $1,000,000 | **33%** |
| **Common Shareholders** | $1,500,000 | **75%** | $2,000,000 | **67%** |
| **Total** | $2,000,000 | | $3,000,000 | |

As shown in the post-investment column in the above table, the VC investor holds 25% of the shares of the company post-investment. When the company is sold, the VC investor receives its 2x liquidation preference of $1,000,000 and the remaining $2,000,000 is split amongst the common shareholders. But, even though the VC investor held 25% of the shares of the company, its 2x liquidation preference allows it to recoup one-third of the proceeds on an exit, as shown in the exit proceeds column in the above table.

In certain circumstances, it is more profitable for a VC to convert its preferred shares into common shares at the time of an exit scenario rather than receiving its liquidation preference. The table below illustrates this based on the previously used scenario (a $500,000 investment, a 2x liquidation preference and a $2,000,000 post-money valuation), but also assumes the preferred shares are convertible to common shares at a conversion ratio of 1:1, and that the company is ultimately sold for $5,000,000.

| | Post-Investment | | Exit Proceeds - No Conversion | | Exit Proceeds - Conversion | |
|---|---|---|---|---|---|---|
| **Investor Preferred Shares** | $500,000 | 25% | $1,000,000 | **20%** | $1,250,000 | **25%** |
| **Common Shareholders** | $1,500,000 | 75% | $4,000,000 | **80%** | $3,750,000 | **75%** |
| **Total** | $2,000,000 | | $5,000,000 | | $5,000,000 | |

As the above table illustrates, if the VC investor did not elect to convert its shares and instead received the liquidation preference, it would receive $1,000,000 of the exit proceeds, whereas if it instead converted to common shares, it would receive $1,250,000 of the exit proceeds. The "inflection point" —when an investor is better off converting to common shares instead of electing to take a liquidation preference—is reached when an investor's liquidation preference (in this case $1,000,000) is worth less than the investor's pro rata ownership of the business (in this case 25%). In this scenario, the inflection point is reached when exit proceeds are more than $4,000,000 ($1,000,000/0.25).

In addition to pure liquidation preferences, some VC investors will try to negotiate for "participating" preferred shares. With these shares, not only does the VC investor receive a liquidation preference, but it also participates with the common shareholders in any proceeds remaining after the liquidation preference is paid. Participating preferred shareholders essentially "double dip" on their return.

The below table showcases the implications of participating preferred shares, based on the previously used scenario (a $500,000 investment, a 2x liquidation preference, a $2,000,000 post-money valuation and the company being ultimately sold for $3,000,000).

| Post-Investment | | | Exit Proceeds | | |
|---|---|---|---|---|---|
| | | | Liquidated preference: | $1,000,000 | 33% |
| | | | Participation in remainder: | $500,000 | 17% |
| Investor Preferred Shares | $500,000 | **25%** | Investor Total | $1,500,000 | **50%** |
| Common Shareholders | $1,500,000 | **75%** | Common Shareholders Total | $1,500,000 | **50%** |
| Total | $2,000,000 | | | $3,000,000 | |

The VC investor initially holds 25% of the shares of the company post-investment. When the company is sold, the VC investor first receives its 2x liquidation preference of $1,000,000. However, instead of the remaining $2,000,000 being divided among the common shareholders only, the $2,000,000 is now divided among the common shares and the participating preferred shares on a proportionate basis. By participating in the remaining funds, the VC investor nets an additional $500,000 above its liquidation preference. Although the VC investor held 25% of the shares of the company, its 2x liquidation preference and participating preferred shares allowed it to recoup one half of the proceeds on an exit.

### *Dividends*

Oftentimes, a term sheet will stipulate that the VC investor's preferred shares will be entitled to dividends. Dividends on preferred shares are usually stated as a fixed dollar amount or percentage of the initial purchase price of the shares (either payable or accrued annually). Dividends can be cumulative, meaning they accrue at regular intervals if the company is unable to pay them, or non-cumulative, meaning that missed dividend payments do not accrue. If the terms of the preferred shares entitle the holder to a specified dividend, then the aggregate amount of any accrued but unpaid dividends are typically included in the amount of the "liquidation preference" payable to the VC upon an exit or liquidation event.

### *Conversion Rights*

Typically, a VC investor's preferred shares will also be convertible into common shares under certain circumstances. The conversion rate of the preferred shares will normally be 1:1, subject to adjustment based on anti-dilution protections (as discussed in more detail below). Similar to a liquidation event, if there are any accrued but unpaid dividends in respect of the preferred shares when converted, the dividend amounts are also typically convertible into common shares at the applicable conversion rate. Preferred shares can be converted into common shares at the option of the holder or automatically in certain circumstances, such as the completion of an initial public offering for gross proceeds of a minimum specified amount and a listing of the common shares on a recognized stock exchange (often referred to as a "Qualified IPO"), or on the approval of a majority of the holders of the preferred shares.

## 3. Control of the Company

Most VC investors will want to negotiate some aspect of control over the company when making an investment. The main ways a VC investor can exert control is through representation on the company's board of directors and through the voting rights attached to its shares.

### *Board Representation*

Depending on the size of an investment, a VC investor may negotiate for representation on a company's board of directors. Representation can range from an "observer," who attends board meetings but cannot vote, all the way to multiple full board seats. The board of directors is the main decision-making body for a company, and therefore, agreeing to grant board representation to a VC investor needs to be carefully considered.

### *Voting Rights*

An investor can also exert control over a company through the voting rights attaching to its shares. The voting rights of preferred shares range from having no voting rights (other than certain minimum rights required by corporate law) to full voting rights similar to those attaching to common shares. In our experience, it would be typical for a VC investor to insist on full voting rights. Sometimes preferred shareholders also negotiate additional veto rights, either individually or as a class of shareholders, over certain specific matters such as issuances of new securities, declarations of dividends, or a sale of the company. Veto rights in particular should be carefully considered before being granted to investors, as those investors will need to be consulted in respect of major decisions, and veto holders could block the company from taking specific actions.

### 4. Protective Provisions

Term sheets will often also include protective provisions regarding a VC investor's preferred shares. Below we discuss five types of protective provisions: pre-emptive rights, rights of first refusal, tag-along rights, drag-along rights, and anti-dilution protections.

#### *Pre-Emptive Rights*

VC investors often negotiate pre-emptive rights (also called pro-rata rights) which provide VC investors, and often other shareholders, the ability to maintain their ownership level of the company throughout subsequent financing rounds. If shareholders are entitled to pre-emptive rights and a company proposes to issue additional shares or securities that are exercisable for or convertible into shares (such as options, warrants, or convertible notes or debentures), the company must first offer the shares to those shareholders to whom pre-emptive rights have been granted. Those shareholders have the option (but not the obligation) to purchase their proportionate amount of the new shares or securities to be issued (based on their current ownership), thus allowing them to maintain their level of ownership of the company.

#### *Rights of First Refusal*

Rights of first refusals (also called ROFRs) are another type of protective provision. ROFRs are similar to pre-emptive rights, except that whereas pre-emptive rights are triggered if the company proposes to issue new shares, ROFRs are triggered when existing shareholders propose to sell the shares they own. In such circumstances, a selling shareholder must first offer their shares for sale to ROFR holders before their shares may be sold to a third party.

#### *Tag-Along Rights*

Tag-along rights (also often called co-sale rights) offer VC investors and other minority shareholders who have negotiated tag-along rights the option to sell their shares to a third party at the same time and price as majority shareholders who propose to sell their shares, thereby "tagging along" on the proposed sale. Tag-along rights are generally an important protective provision for VC investors and other minority shareholders because selling a minority interest in a private company can be difficult, particularly if the founders have previously sold some or all of their shares. Tag-along rights, therefore, provide greater liquidity for a VC investor's shares if they represent a minority interest.

#### *Drag-Along Rights*

Drag-along rights are essentially the inverse of tag-along rights, where holders of a specified minimum percentage of the shares or each class of shares (the "dragging" shareholders) have the right to force the remaining shareholders to participate in a sale of a company's shares to a third party. The purchaser must offer the other shareholders the same price, terms and certain conditions that the dragging shareholders have been offered. Drag-along rights provide liquidity, flexibility and an easy exit route for shareholders to sell their interests in a company and recoup their investment.

### *Anti-Dilution Protections*

Anti-dilution rights protect an investment from being diluted or becoming less valuable. While some anti-dilution protections for preferred shares are non-controversial (e.g., protections against dilutions resulting from stock splits), others can be more heavily negotiated, such as pricing anti-dilution protection. If preferred shares are entitled to pricing anti-dilution protection, it means that if the company issues shares at a price lower than the price per share paid by the VC investor, the conversion price of the VC investor's preferred shares are adjusted in their favour. Typically, certain share issuances are excluded from pricing anti-dilution adjustments; for example, shares issued (i) upon the exercise of stock options under an approved stock option plan, (ii) upon conversion of a previously issued convertible preferred share, (iii) as stock dividends, or (iv) occasionally to satisfy the purchase price for the bona fide acquisition of shares or assets of a third party.

The most common way to adjust a conversion price is by a weighted-average adjustment, which considers the number of shares issued in the subsequent financing and the price of such shares. A more aggressive adjustment mechanism is a "full ratchet" approach. If preferred shares are protected by full ratchet pricing, even if one new share is issued by the company at a lower price, the conversion price of all of the preferred shares will be fully ratcheted down to the new price.

## 5. Due Diligence

Typically, if a company reaches the term sheet stage with a VC investor, the VC investor will have already conducted preliminary due diligence on the company. Nevertheless, term sheets will include a provision allowing the VC investor and its legal and financial advisors to conduct further due diligence on the company, and as a condition to closing the VC investor must be satisfied with the diligence results. The due diligence process can vary from deal to deal but typically takes at least 14-30 days to complete.

We also encourage founders to conduct reverse due diligence on potential VC investors. Allowing a VC firm to invest in your business is an important decision; a good VC partner can become a trusted advisor and help your business grow. However, if the investor is not a good fit, there can be serious negative repercussions. In fact, sometimes it may be preferable to accept a lower valuation from a VC firm that has considerable expertise and a broad network of contacts within your industry, and that can therefore add significant value to the business.

Understanding a potential VC firm and assessing if it is a good fit ahead of time is very important and can be done by asking questions about the VC firm's track record, long-term values in building businesses, and how it handles disagreements and conflicts. Another way to conduct diligence on a VC firm is to ask to speak with founders at other portfolio companies in which the VC firm has invested, to get a first-hand account of what it is like to work with the VC firm.

## 6. Binding Versus Non-Binding Nature of Term Sheets

Another aspect of a term sheet that is important to understand is whether it is non-binding or binding, which should be explicitly stated. A binding term sheet means a legally binding obligation is created in respect of the matters discussed in the term sheet. A non-binding term sheet indicates that the term sheet summarizes the parties' intentions but does not require the parties to close the deal. In VC financings, most term sheets are non-binding in general but often include specific binding provisions. The overall non-binding nature means that even when the term sheet is signed, the deal terms are subject to change, and either party could walk away from the deal. While it is frowned upon for either party to re-trade fundamental deal terms after signing (absent exceptional circumstances), if a term sheet is non-binding, it does not preclude either party from doing so. Typically, even if the overall term sheet is non-binding, certain clauses such as confidentiality provisions (which require that parties not disclose the term sheet or related information to third parties) and exclusivity or "no-shop" provisions (which require the company to exclusively deal with the VC investor for a certain period of time) are normally binding.

### Conclusions

Negotiating a term sheet can be an exciting, complex, and sometimes overwhelming task for founders. Though this update has only scratched the surface of the ins-and-outs of term sheets, we are hopeful that it will serve as a helpful roadmap for start-ups embarking on a VC capital raising process. As always, it is advisable to engage experienced counsel early in the process to help facilitate negotiations and protect you and your business.

If you have any questions regarding the matters discussed above, please contact Rebecca Cochrane (rcochrane@wildlaw.ca), Troy Pocaluyko (troy@wildlaw.ca), Nick Robelek (nrobelek@wildlaw.ca) or any other member of Wildeboer Dellelce LLP.

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