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START-UP FIRST TERM SHEET: STUMBLING BLOCKS TO AVOID

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Amalian A. W., Amalyan N. D. Start-up First Term Sheet: Stumbling Blocks to Avoid

Start-up relationships with business angel and/or venture capital are similar to a marriage – but with a divorce in mind. The latter necessitates a proper prenuptial agreement signing at the very beginning of the relations. In case of business angel and/or venture capital we are speaking about Term sheet, determining pricing, powers and duties of the board, as well as information, participation and protective rights for the partners. Standard Term sheet consists of three buckets of provisions, defining: (i) terms impacting start-up valuation and economic division of profits and proceeds upon a liquidity event, (ii) terms impacting control over decision making and (iii) investor protection terms. This article focuses on financial and economic aspects of funding agreement, exposing some tricky parts of the Term sheet, threatening to transform potential win-win deals into rupture of relations, crash of the company or even legal battles. The results of the analysis are used to substantiate growing in popular appeal thesis that raising too much money can be detrimental for a startup.

Keywords: *start-up, term sheet, business angel, venture capital, convertible securities.*

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Амалян А. В., Амалян Н. Д. Перший для стартапу протокол про наміри: камені спотикання, яких слід уникати

Відносини стартапу з бізнес-ангелом та/або венчурним капіталом схожі на шлюб, але з планами на розлучення. Останнє вимагає наявності із самого початку підписаної шлюбної угоди. У випадку відносин із бізнес-ангелом та/або венчурним капіталом ми маємо на увазі терміни, методи ціноутворення, права та обов'язки ради директорів, захисні застереження для партнерів та їх права на інформацію та участь. Стандартний протокол про наміри складається з трьох пакетів положень, які визначають: (i) умови, що впливають на оцінку компанії та розподіл прибутку та доходів у разі події ліквідності; (ii) умови, що впливають на контроль за прийняттям рішень; та (iii) застереження, спрямовані на захист інвесторів. У даній статті основна увага приділяється фінансовому та економічному аспектам угоди про фінансування; виявляються деякі каверзи, зафіксовані в протоколі про наміри, що загрожують привести потенційно безпрограшні угоди до розриву відносин, краху компанії або навіть судових тяганин. Результати аналізу використовуються для обґрунтування твердження, що набуває все більшої популярності, про те, що залучення занадто великих інвестицій може виявитись для стартапу шкідливим.

Ключові слова: *стартап, протокол про наміри, бізнес-ангел, венчурний капітал, конвертовані цінні папери.*

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Амалян А. В., Амалян Н. Д. Первый для стартапа протокол о намерениях: камни преткновения, которых следует остерегаться

Отношения стартапа с бизнес-ангелом и/или венчурным капиталом похожи на брак, но с видом на развод. Последнее требует наличия изначально подписанного брачного соглашения. В случае отношений с бизнес-ангелом и/или венчурным капиталом мы имеем в виду сроки, методы ценообразования, права и обязанности совета директоров, защитные оговорки для партнеров и их права на информацию и участие. Стандартный протокол о намерениях состоит из трех пакетов условий, определяющих: (i) положения, влияющие на оценку компании и распределение прибыли и доходов в случае события ликвидности; (ii) положения, влияющие на контроль за принятием решений; и (iii) оговорки, направленные на защиту инвесторов. В данной статье основное внимание уделяется финансовым и экономическим аспектам соглашения о финансировании; выявляются некоторые подвохи, содержащиеся в Протоколе о намерениях, угрожающие привести потенциально беспроигрышные сделки к разрыву отношений, краху компании или даже судебным тяжбам. Результаты анализа используются для обоснования приобретающего все большую популярность утверждения, что привлечение излишне крупных инвестиций может нанести стартапу вред.

Ключевые слова: *стартап, протокол о намерениях, бизнес-ангел, венчурный капитал, конвертируемые ценные бумаги.*

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For the last decades Ukraine is witnessing incursion of foreign investors, taking on the role of business angels, venture capital or private equity funds. In 2016 only on local tech investment market there were registered 87 deals (32 % growth in number vs 2015) with $88 million invested (125 % up over 2014) [1]. The *aim* of the article is to analyze alternative options for cooperation of business angels and/or venture capital with Ukrainian start-ups (the number of which, according to the Ukrainian Venture Capital and Private Equity Association report, currently runs up to 3,000) in order to preclude possible misunderstanding of commonly, as well as rarely, used terms of agreement.

There is no fundamental research regarding theoretical or practical aspects of funding start-ups' private equity published in Ukraine. Numerous fundamental and applied papers, published in foreign literature, provide definition of the terms [2–5], description of the main economic and legal components of a standard term sheet [3; 6; 9–24], and a lot of trainers for novice businessmen. Brief review of them will be given in relevant paragraphs of the article.

In business literature the term start-up is attributed to the second stage of the business life cycle (following the seed stage). For ease of reference in this paper the term "start-up" is applied to any company that exists legally, is short of money and attempts to capitalize on developing a product or service for which the founders believe there is a demand. As Elliot Harris stated, "a company is considered a start-up until they stop referring to themselves as a start-up, or until their IPO" [2].

Initial infusion of money needed to turn the idea into some profitable product usually occurs in a form of a round financing: first, there comes a seed round (money provided by 4Fs — founder, family, friends, and fools), next in line are business angels and venture capital (series A, B, C, etc.). The end result of each round is redistribution of ownership in favor of new investors.

Depending on the performance of a start-up, rounds can be Up (with valuation increasing with each round), Flat (start-up raising capital at the same valuation as the previous round) and Down (next valuation lower than the previous one). The last one provides for the sale of a higher number of shares for smaller investments.

Business angel (also called "informal investor", "angel funder", "private investor", "seed investor", etc.) is "a high-net-worth individual who takes a big risk on one or two people at the beginning stages of the company. They invest locally and provide consultation, direction and advise" [3].

Venture capital is "formal" or "professional" equity, in the form of a fund run by general partners, to invest in early to expansion stages of high growth firms [4].

Both angel investors and venture capital funds are subsets of the broader **private equity** asset class. "Angel investors have one essential and primary goal identical to that of venture capitalists – they are in the business of making money" [4].

Investing in companies at the earliest stages of their development both subsets of private equity are exposed to high level of risk: about three-quarters of venture-backed firms in the U.S. don't return investors' capital, according to recent research by Shikhar Ghosh, a senior lecturer at Harvard Business School [5]. To compensate expected losses both angel investors and venture capital funds are expecting for high return on investment in successful firms ($2x$ – $10x$).

Term sheet (also known as Letter of Intent, Memorandum of Understanding, and Agreement in Principle) is a nonbinding agreement setting forth the basic terms and conditions under which an investment will be made. As Stephen R. Poland notes, a term sheet is not a contract or a promise to invest but rather an agreement in principle that outlines the terms of the investment deal. Just because you have a signed term sheet does not mean the investment deal is completed [6].

Done well, the term sheet leads to genuine partnership and mutually beneficial activities. Done poorly, it can lead to conflict of interest, mutual (or unilateral) dissatisfaction, losses of cash and even trial proceedings.

Each business has unique characteristics and each term sheet is unique. Specific features of each term sheet are determined by the following criteria:

- stage of the company (availability of any revenue);
- stage and results of team building;
- stage of the market (availability of competitors);
- money required to reach pre-concerted milestone and/or need for additional investments).

But alongside with differences there are generalities in all term sheets, inclusive of the regulations, defining:

(1) terms impacting valuation and economic division of profits and proceeds upon a liquidity event;

(2) terms impacting control over decision making;

(3) investor protection terms[1].

The first of them is a main subject matter of the presented analysis, while the last two are mentioned only as points to negotiate possible trade-off between particular provisions of a specific term sheet.

(1) Financial terms and conditions.

One of the first steps in the process of term sheet negotiations is the valuation of a company to invest in.

As a rule at the early stages of the business life cycle partners are evaluating a business without (i) any ready for sale product/service, (ii) any fundamental financial data and (iii) any revenues: such companies earn a negative cash flow, have cash flow gaps and make no profits. In addition they are characterized by a high level of un-

[1] Another possible classification of the clauses of the term sheet singles out provisions relating to (i) getting into a deal (valuation, mode and size of investment), (ii) staying in the deal (management and control) and (iii) exit (splitting proceeds from sale).

certainty and risk: management team risk, product development risk, market risk, exit risk [7].

Several concepts relating to the valuation process are as follows:

a) ***Dilution*** is a reduction in the ownership percentage of a share of stock (i) caused by issuance of new shares or (ii) when holders of stock options, such as company employees, or holders of other optionable securities exercise their options.

When the number of shares outstanding increases, each existing stockholder owns a smaller, or diluted, percentage of the company, making each share less valuable.

b) ***Fully-diluted capital.*** A company's fully-diluted capital is the sum of the number of shares of the company's common stock immediately prior to the financing, including (a) outstanding shares, (b) issuable pursuant to outstanding convertible securities (like preferred stock), (c) issuable pursuant to exercisable securities (like options and warrants) and (d) otherwise reserved for issuance pursuant to the company's option plan(s).

c) ***Pre- and post-money valuation.*** Pre-money valuation is the valuation of a company prior to an investment. Post-money valuation refers to the value of a company after an investment has been made.

Disregarding the difference in the term sheet can cause complications in future relations of the partners: while founder, on the assumption of the valuation being pre-money (say $1 million), considers investor's share ($500 000) to be 33%, business angel can claim 50% of the company, stating that $1 million was post-money valuation.

From an investor's perspective post money valuation is the denominator in determining ownership with the numerator being the amount invested by him/her.

At present there are at least 9 alternative methods of start-up valuation. As Stéphane Nasser characterized them, "...valuations are nothing but formalized guesstimates. Valuations never show the true value of your company" [8]. They just show two things: (1) how bad the market is willing to invest in a start-up, and (2) how bad a start-up is willing to accept it. The deduction: over-optimizing a valuation often isn't worth the time and goodwill that it eats up.

One way of bypassing the need of an immediate formal start-up valuation is structuring investment in the form of convertible notes (debt securities, providing their holders with a possibility to convert their creditor position to that of an equity holder on an agreed-upon terms).

d) ***Price for share*** is the pre-money valuation of the company divided by the number of shares outstanding prior to the investment.

The moot point behind the negotiation of the definition of "price per share" is related to deciding who will bear the cost of dilution. An example of such eventual dilution is an option pool consisting of call options on stocks reserved for present and/or future employees of a private company. Such option pool, acting as a method of motivating and retaining employees, is often used to attract and/or reward employees in a startup company and is usually restricted in cash.

If the number of the securities in question (say, options) is included in the fully-diluted number, the existing common stockholders will assume all of the diluting effect of those securities. If those securities are not included in the fully-diluted number, the existing common stockholders and the new investors will assume on a pro rata basis the diluting effect of those securities.

The investors will argue for a larger fully-diluted basis (i.e., one including the unissued options) so that the existing common stockholders will assume the diluting effect when those options are issued and exercised. This will result in "founder dilution" – the amount of ownership given up by start-up founders in exchange for cash injected by an investor.

The company will argue for a sharing of the diluting effect of the unissued options equally between the existing common stockholders and the new investors [9], stating that new hires benefit everyone and should dilute everyone [10].

Next moot point in term sheet negotiation is related to **investment instruments**, defining the tools for business angels or venture capital to invest in. Till recently they could be equity (common, preferred or preferred convertible stock) or debt securities. At present the store of instruments is reinforced by stock options, warrants, SAFEs and KISSes.

SAFE is the abbreviation for Simple Agreement for Future Equity — alternative to convertible debt, introduced in 2013 by the startup accelerator Y Combinator; KISS is the abbreviation for Keep It Simple Security, introduced in 2014 by the start-up accelerator 500 Startups. Note-alternatives are contractual rights to purchase the company's equity at a future date, similar to warrants, but the conversion price remains undetermined until a later date. Like convertible debt, note-alternatives are a quick and simple way of providing companies with cash in exchange for the promise of future equity. A major difference is that note-alternatives generally do not accrue interest and do not have stated maturity dates. Until the note-alternative converts into stock, note-alternative holders typically have no management rights and do not share in any dividends that are paid; they are not treated as debt on the company's balance sheet

Both debt/equity hybrids have already become an increasingly popular tool for investing in early stage companies [11].

In case of equity funding, if **common stock** is to be purchased directly, or upon the conversion of other securities, the parties should negotiate whether the common stock is to be of the same class or series as existing shares of common stock. If **preferred stock** is involved,

the parties should indicate the **rights, preferences, restrictions, conversion rights (and conversion ratio), voting rights** and other special or relative rights of such preferred stock[2].

The basic rights of each class of stock will be set forth in a company's **"charter"**. Usually the charter also defines **"vesting"** – the schedule of actual distribution of the shares that are promised to people who are involved with the startup. This is one of the investor's protective clause, guaranteeing that the founder is staying with the start-up. To prevent them from leaving the company, it is usual to "vest" their shares over a space of several years, based on their staying with the company for that entire period. If the vesting period is four years, which is rather typical, the person might receive one-quarter of their promised equity at the end of each year, or they might get a fractional amount at the end of each month. This process incentivizes the employee to truly invest their full effort into the success of the business [12].

In case of the acquisition of the start-up by another company that does not need the founder to stay employed, the charter can stipulate for recognition that in such a situation the founder (or any other stockholder) is effectively denied the opportunity to earn the unvested stock, and therefore the clause of acceleration on the vesting on founders' equity should become effective[3].

If **debt** securities are involved, the parties should state whether the debt is to be (i) convertible and (ii) **subordinate** to debt from third parties.

Angel investors often invest through **convertible** debt. This involves the investors loaning money to the company, with the loan amount being convertible into equity shares of the startup, "a loan from investors that is never meant to be paid back" [13]. The principal advantage of this structure is that the parties can defer fixing a valuation on the enterprise until a future financing round. When the future round is complete, the debt converts into equity shares at the purchase price determined at that time. The point to negotiate is whether and at what level a "capped" round should be fixed.

Expediency of this specification is based on the uncertainty of the future priced round. If the price on that future round is set high, the entrepreneur wins and gives less stock to the note holders. If the price is set low, the investors win and get more stock for their original investment. To alleviate the problem the parties can set a "valuation cap" or the maximum valuation an investor will convert his/her investment into shares.

If, for example, a company raises $500,000 in convertible notes at a $5 million cap, it means that investors will own at least 10% of the company when it raises a later round of funding (500K/5MM). An uncapped round, more favorable to the entrepreneur, means that the investors get no guarantee of how much equity their money purchases. If the same company raises $500,000 in an uncapped round and later convince new investors to value the company at $10 million, convertible note investors will be left with just 5% of the company. In the USA the median valuation cap for convertible notes in 2016 remained steady at $6MM [14].

Also, to compensate creditors for the risk that they take in funding early stage companies, in the term sheet there can be included a provision of conversion discount from the Series A price or a separately exercisable warrant to purchase an additional percent of shares (typically, at a nominal price per share).

Accrued interest rate on convertible debt and/or **accrued dividends** on equity shares, as a rule, are not payable in cash. For the most part they accrue and are converted into equity shares at the same time as the principal amount of the loan. There are no set standards for **accruing return** rates, but most commonly the rates vary between 4% and 8% [14].

The term "cap" can be seen in the term sheet once more – in the section, regulating liquidation preferences (preferred return) – a clause for investors to get their money back "off the top" of any acquisition price.

There are three alternative modes of proceeds payment. In all of them preferred stockholders are entitled to receive a "preference" – typically some multiple of their original investment (1x-3x) plus any accrued and unpaid dividends – before any payment is made to the common stockholders. "Participating" preferred stockholders are also entitled, after payment of their preference amount, to share with the common stockholders, on an as-converted-to-common basis, in the distribution of any remaining proceeds (this is called "double dipping"). If there is a right to participate with the common, the right may be capped at a multiple of the preferred stockholders original investment [15].

General rule: anything that is stated serves as a precedent for future rounds – future investors will demand just as well or better clauses. Usually this consuetude bounds appetite of early investors.

(2) Control and Voters' rights.

Next critical point in a term sheet is connected with the determination of the **Board structure and reporting.**

While there are no common rules, angels will have valuable business insight but they are involved in the management of the business only if they wish to: usually they do not require some formal representation on a startup's board of directors. Some of them require certain reporting procedures — such as monthly sales or product development updates. Contrary to them, venture capitalists, bringing more funds into business, almost always

[2] Preferred shares tend to be issued in series, with a separate series (A, B, C) denoting each round of investor financing.

[3] Acceleration can be triggered by the sale of start-up or by involuntary termination (single-triggered); if both causes are in hand, such acceleration will be labeled "double-trigger".

tend to demand more control of start-up spending and strategic decisions, thus requiring board seats and more control.

As the editor of the blog *The Venture Alley* Trent Dykes points out [16], control comes at two levels and in two forms:

- control rights can relate to board of director-level actions, shareholder-level actions or both;
- the standard methods of implementing control rights are blocking rights and approval rights.

Controls with respect to board-level decisions can be implemented in two ways that are often utilized simultaneously. The first is the ability or right to appoint directors to a company's board that arises from:

- a voting agreement whereby the company's shareholders contractually agree to vote for the director(s) designated by a specified constituency;
- an express designation of a board representative elected by a specified class or series of stock and/or;
- restrictions added to the company's Articles limiting the size of the board.

The second method of allocating control at the board level is by increasing the approval threshold required for various identified actions or providing with a right to veto specific decisions, providing certain parties with "blocking" rights.

Usually the board is odd numbered and generally falls along the lines of the cap table[4]. The typical structure – 2 from common shareholders including CEO, 2 from preferred shareholders and 1 outsider. The smaller number, the better, because future rounds of funding are expected to bring new directors.

Shareholder Controls can be exercised with the help of a number of mechanisms in order to increase the control of one or more groups of shareholders, such as the founders or all holders of a certain series of stock. The most common ways that can be used in combination are the following:

- separate shareholder class voting rights (*referred to as* "protective provisions") requiring approval by the holders of a particular class or series of stock for certain specified corporate actions, thereby giving those shareholders veto rights over such action being taken, even if approved by the board;
- a requirement for approval by a larger number of shareholders than the default required by law;
- the grant of contractual rights to certain shareholders to purchase some or all of the stock sold by the company in the future (aka preemptive right clause);
- a contractual requirement that all shareholders agree in advance to approve certain actions under specified conditions (aka drag-along clause), and other.

Common categories covered by negative control rights (blocking undesired outcomes) are dissolution or winding up of the corporation; merger or sale of the corporation or its assets; amendments to the corporation's charter; issuing new or redeeming present securities; paying dividends; borrowing money (above a specified threshold) and changing the number or representation of directors [17]. Such negative controls are tightly intertwined with protective provisions.

(3) Protective provisions often appear in one of two forms: standard and controversial.

Standard protective provisions regulate:

- a sale of the company or other "Liquidation Event";
- any amendment to the company's Certificate of Incorporation;
- any increase or decrease (other than by conversion) in the total number of authorized shares of Preferred Stock or Common Stock;
- the authorization or issuance of any equity security having a preference over, or being on a parity with, any series of Preferred Stock with respect to dividends, liquidation or redemption;
- the redemption or purchase of shares of Preferred Stock or Common Stock;
- any declaration or payment of any dividends;
- any change in the authorized number of directors of the company [18].

Beyond the usual provisions, some investors will push for **Non-standard/Controversial protective provisions** regulating any hiring, firing or change in the compensation of any executive officers; the entering into any transaction with any director, executive or employee of the company; any incurrence of indebtedness in excess of $[…]; any change in the principal business of the company or the entering into any new line of business; any purchase of a material amount of assets of another entity.

As the author of 6 bestsellers Ross Blankenship noted, "controversial terms should be avoided where possible; they only lead to conflict. These are often injected in one-sided affairs that may create immediate power but long-term bad blood, and that can kill a company's magic early before fruition" [19].

Ability of founders to push back them depends on the strength of their negotiating leverage. But it is expedient to remember that any term sheet is a trade-off between its financial terms and protective provisions.

In **conclusion** of the analysis of the term sheet it is rationally to mention some steps preceding its negotiation. They are (i) the finding of the expediency of raising

[4] A start-up capitalization table is a spreadsheet or table that shows capitalization, or ownership stakes, in a company and the various prices paid by stakeholders for these securities.

funds from business angels and/or venture capital, and, if the answer is positive, (ii) calculation of the amount of required investment.

More than two generations ago, the venture capital community, that is, VCs, business angels, incubators and all the rest convinced the entrepreneurial world that writing business plans and then raising venture capital constituted the twin center pieces of entrepreneurial endeavor. Reflexively founders wanted to raise as much money as they can, thinking it would give them more resources, more time, better chances of competing and a longer runways before they have to go asking, once more, for money [20]. All too often, entrepreneurs would think of raising a Series A round from a reputable VC as the end goal and don't think they can be successful unless they do so [21].

Contrary to this way of thinking, at present more and more scientists and businessmen state that "raising too much money can harm your startup" [20]. "When someone gives you venture capital, it's like someone handing you a grenade with the pin pulled. If you know what to do with it, it can be very useful, if you don't know what to do with it, it can blow up in your face," said seasoned investor Wright Steenrod. "Money comes with a lot of baggage. Investors will not own a majority of the firm, but they will have a degree of control, including the ability to get the entrepreneur fired", adds John Mullins. London Business School has even designed the special course "How to Finance and Grow Your Startup – Without VC" [22].

In deference to these specialists it is appropriate to mention their arguments. The first group of them covers interest of investors.

As a rule, early-stage investors need to imagine making a minimum of 10x their invested capital [20]. At the same time, as practice demonstrates, on early-stage round investors want to own in average 20-25% of the start-up they invest in. Elemental calculation shows that asking for $5 million means that at present the entrepreneur values his/her start-up at $20–25 million with a promise of future price of the company at least at $100– 200 million. The last figures will be used by next round investors as pre-money valuation of this particular start-up.

And if the entrepreneur raises the "5 on 20" and fails to grow into his/her next-round valuation he/she is stuck because venture investors hate doing down rounds.

The second group of arguments covers founders' interests. The best review of them was presented by Fred Wilson: "The fact is that the amount of money start-ups raise in their seed and Series A rounds is inversely correlated with success. Yes, I mean that. Less money raised leads to more success. That is the data I stare at all the time" [23]. "Whatever you raise, investors expect something in return and will own part of the company," further urges Wharton finance professor Luke Taylor. "The founders' stake will get diluted. So the more cash you raise, the more of the company you have to give away" [24]. In other words, the further you are estranging yourself from your dream to be your own boss. ■

LITERATURE

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