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5 Tips for Negotiating Term Sheets with US VC Investors

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We are often asked what to watch for when reviewing or negotiating US term sheets. Below are five key concepts non-US founders – and founders generally – should understand.

Note that this discussion assumes investment into a US holding company. Investments into UK or other non-US holding companies will present similar issues, but with some differences due to the nuances of the applicable non-US law.

Valuation and Total Financing Amount

Founders need to intimately understand valuation. Simply put, your startup's valuation is what a group of reasonably sophisticated venture capitalists ("VCs") believe your sweat and tears should be worth prior to their investment. In a term sheet, this often is expressed in terms of a "pre-money" valuation, i.e., the value of your company *prior to* the investment round at hand. Your "post-money" valuation reflects the value of the company *following* the investment round. For example, if you have a pre-money valuation of $3,000,000 and your investors are putting in $2,000,000, your post-money valuation is $5,000,000.

Your valuation establishes what percentage of your company your investors will own following their investment, and the terms of that valuation will dictate some of the most critical aspects of control and capitalization. In the example above, your investors will own 40% ($2M out of $5M) of the company following the round. Assuming there aren't any special controls in place or stock with supervoting power for the founders, this also means that the investors have roughly 40% of the voting power in the company. Investors with significant voting power, coupled with the unique voting rights and board seats often granted in a financing round, can change the dynamics of a company in ways that founders may be unprepared for. In our experience, this shift often surprises non-US founders who may be unaccustomed to having investors play an active role in company management.

Keep in mind is that a high valuation may not always lead to the best outcome for the company. Many founders pursuing a high valuation inadvertently cede control and value that can demotivate early employees. A high valuation can be enticing, but if it requires you to relinquish a significant percentage of equity or accept draconian terms, you need to consider how that will impact the business going forward. For many US-based companies, equity is the best way to

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retain strong employees; devaluing and diluting them can trigger an often-irreversible exit in top talent.

Unfortunately for founders seeking the definitive guide to negotiating valuation with US VCs, there isn't any one "right way." Concepts like multiples of earnings or trailing revenues are poor guides for growth companies that frequently have no or negative earnings. US VCs instead often look at the founding team's experience, the strength and complementary nature of a team, market size and growth prospects, and whether the company is operating in a desirable sector for investment.

Non-US founders should preempt and address any weaknesses in areas where you may be uniquely disadvantaged compared to your US peers. If most of your team is located outside the US, be ready to explain how that helps to maximize efficiency across time zones. If your team is mainly experienced in non-US markets, stress how that expertise paired with your investor's US network makes you an ideal match to create a dominant global player. The founders who will have the most success in obtaining a favorable valuation from US investors are those who have invested time and resources into identifying the US investors who will be most interested in the opportunities these dynamics present.

Board and Management Changes

A standard term sheet in a major financing round (e.g. Series A, Series B, etc.) will usually contain provisions relating to the board of directors and management. The investor investing the most substantial amount of money (your "lead" investor) will often request one board seat to represent that entire series of preferred stock going forward until the company's eventual exit. This may seem peculiar to some non-US founders, but this is standard fare. US VCs often leverage their networks and connect companies with complementary portfolio companies to enhance the overall value of their investments. Many individual directors are also former entrepreneurs from similar industrial backgrounds, and a great VC can complement the management team to stimulate growth.

However, the influence a board member can have on an early-stage company's direction and dynamics requires founders to be vigilant in vetting potential new additions. This can be a particularly thorny issue where there are three founders; in many cases, one of the founders will be asked to step down to accommodate the first "Preferred Director." As the company raises more in financing, the board composition will change such that the founders may eventually lose majority control. In these instances, without certain protections the board may be able to demote or fire the founders, change the company's direction or sell the company over the founders' objections. For these reasons, choosing good board members is critical. As the board grows, the company should strive for an odd-numbered board and consider adding independent directors to avoid any deadlock resulting from an evenly-numbered board.

Be prepared to provide your minor institutional investors with a letter referred to as a "Management Rights Letter." These may seem completely alien in their unscrupulous use of

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legalese, but these letters help investors without board seats or board observer seats satisfy US requirements for laws pertaining to certain types of capital allocators and are not an overreach for managerial control. Your US counsel should of course review for anything out of the ordinary, but try to save your budget at the term sheet stage for more critical battles.

Liquidation Preference

A "liquidation preference" refers to the amount of money an investor will receive in the event the company "liquidates." Understanding this concept will help a non-US founder understand the dynamics at play as the company matures and prepares to successfully exit in the US market. Prior to getting to this point, a non-US founder should be familiar with the general model of a US venture capital fund.

US venture capital funds generally invest on behalf of other entities often known as limited partners ("LPs"). They typically try to guarantee some return on the LPs' investment over a 5-10 year life cycle of the fund in exchange for a minor initial percentage (1-2%) of the investment and a larger percentage of successful investments over time (20%+). Rather than making relatively limited, targeted investments based off of conventional metrics with the aim of steady returns on the LPs' investment over time, the venture capital model relies in large part on "casting a wide net" and investing over a range of companies. VCs do so with the expectation that a majority will not fully return their initial investments or return their investments at a rate to satisfy the LPs in isolation. Instead, they rely on investing in the next "big thing," such that other losses or modest gains are eclipsed by a few superstar investments (often referred to as "home runs," to borrow a term from American baseball)

The liquidation preference relates directly to the US VC fund's business model. It is a standard term in US VC term sheets that pertains to the type of "downside protection" investors seek in the event that the company underperforms. Often, this is in the event of dissolution of the company or where the company is acquired for an amount less than the value in which it is warranted for the VCs to convert into common stock to sell their shares.

The liquidation preference will be expressed as a multiple of the initial amount of invested capital for the investor, and will usually start at 1x. That is, in the event of a liquidation, for every $1 they put in, investors will get back $1 according to a 1x liquidation preference. If a company is doing poorly or in particularly bad investment climates, investors may attempt to negotiate this up to 1.5x or, in extreme cases, 2x and beyond. In the latter's case, this would mean that an investor is entitled to receive $2 for every $1 they initially contribute. Generally, where there aren't enough funds to pay out everyone as part of liquidation, this liquidation preference will require that the preferred holders be paid before the founders or other employees get paid.

To add one final wrinkle, a liquidation preference can be "participating" or "non-participating." Participating means that after the preferred investors receive their initial liquidation preference (i.e. the $1 they initially invested) they *also* are entitled to "participate" with the common stockholders (i.e. the founders and employees) in receiving proceeds. This is highly atypical in

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today's venture world for healthy companies, and non-US founders should be skeptical of investors requesting such rights absent other relevant factors. A non-participating liquidation preference simply returns the investor's liquidation preference in the event of a liquidation.

A participating preference or a preference exceeding 1x warrants particular attention in your term sheet. A 1x, non-participating liquidation preference is standard, and nonstandard liquidation preferences can misalign the interests of the company and the investors. Investors with generous liquidation preferences may be incentivized to sell or liquidate in situations in which they are benefited uniquely as preferred stockholders. This dysfunction can become particularly pronounced when major preferred investors are also board members.

Voting Rights and Changes of Control

Closely related to the concepts of valuation and ownership are terms related to voting and control rights. In the term sheet, voting rights pertain to and cover a broad spectrum of terms (which we'll discuss in our upcoming article series dissecting US term sheets in more detail), but there are two key concepts that non-US founders should understand about US corporations to understand how the rights and privileges they give to investors can affect the control of the company and ultimately, how and whether it succeeds.

- **Classes of Stock**: In a typical US venture-backed company, there are two broad classes of stock representing ownership in the company: (i) Common Stock and (ii) Preferred Stock. Common stock is held by the founders, given to employees, consultants and other service providers, and generally has one vote for every one share. Preferred Stock will generally *also* have one vote for every one share initially, but it also comes with a bundle of other rights, privileges and preferences (hence, "Preferred") over the Common Stockholders. Preferred Stock can generally convert into Common Stock at a Preferred Stockholder's option or upon certain events happening such as the company's liquidation or sale.
- **Series of Stock**: Complicating things further, each class of stock can also have separate Series. These series are often broken down alphabetically, starting with A (e.g. Series A, Series B, etc.). Generally, you will be issuing a series of preferred stock as part of your financing you are negotiating in the term sheet.

A substantial part of your term sheet negotiation pertains to the particular voting and control rights you attach to the Preferred Stock issued in the financing. A standard term sheet will describe certain "protective provisions" that will be inserted into the company's charter that gives a certain percentage of these Preferred Stockholders particular voting rights before the company can take action, such as amending the charter, selling the company, or changing the size of the board. It might also contain a "drag along" provision, which may require founders and major shareholders to vote in favor of a "change of control" (usually a merger or sale of the company) if the board of directors and a certain percentage of the stockholders vote in favor of the transaction above the founders' objections.

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Understanding the relationship of these voting rights and control dynamics to the company's valuation is critical to non-US founders negotiating term sheets with US investors familiar with the space. Along with the substantial control VCs receive from their board position and general rights as stockholders, special voting rights can give them a unique voice at the table when entrepreneurs wish to take action. The influence your investors can wield on the company's future is another reason to carefully vet your term sheet and investors thoroughly.

Founder and Employee Vesting and Capitalization Changes

A final concept we see in many term sheets involves employee vesting and company capitalization changes. It is not uncommon for a US VC to request a founder or key employees who are substantially vested in or outright own their shares to subject their stock to "revesting." Put simply, this means that the employees grant the company a right to repurchase their shares if the employment relationship is terminated, although there may be exceptions granted for certain types of terminations. VCs may also request that all employees be subject to standard vesting terms moving forward.

Companies raising US venture capital may also be asked to make substantial capitalization changes before being funded. For companies with large teams or inactive founding members holding substantial equity stakes, they may be asked to repurchase the shares or terminate relationships. Having these conversations can be difficult for those unprepared to navigate those issues.

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For a non-US company with global aspirations, the US represents a massive opportunity to raise significant capital and establish valuable relationships. Understanding what to look for in the term sheets proposed by potential US investors is crucial to ensuring the company is in the best possible position to capitalize on the opportunity.

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