The Art of the Venture Capital Term Sheet

UCLA First Fridays

September 7, 2018

Presented by:
George Colindres, Senior Counsel
gcolindres@perkinscoie.com
Presentation Overview

- Term Sheet Provisions
- Q&A
- The Financing Process (if we have time)
Term Sheet Provisions

OVERVIEW

• Price and Valuation
• Liquidation Preference
• Anti-Dilution: Full Ratchet vs. Weighted Average
• Board Composition
• Drag-Along Rights
• Protective Covenants
• Information and Registration Rights
• Participation Rights
• Rights of First Refusal and Co-Sale
Term Sheet Provisions

**PRICE AND VALUATION**

- Pre-Money and Post-Money Valuations
- Based on “Fully-Diluted” Capitalization
- Treatment of Stock Option Reserve
### Example Capital Structure

**Series A Financing**

<table>
<thead>
<tr>
<th>Category</th>
<th>Shares</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>4,000,000</td>
<td>40%</td>
</tr>
<tr>
<td>Option Pool</td>
<td>2,000,000</td>
<td>20%</td>
</tr>
<tr>
<td>Series A Preferred Stock</td>
<td>4,000,000</td>
<td>40%</td>
</tr>
<tr>
<td>“Fully-Diluted”</td>
<td>10,000,000</td>
<td></td>
</tr>
</tbody>
</table>

- “Pre-Money” is $3,000,000, so
  
  Series A Price = $3.0MM / 6.0MM = $0.50 per Share

- $2,000,000 Investment (at $0.50) = 4,000,000 Shares

- “Post-Money” is $5,000,000

- Called a “2 on 3” Round
### Example Capital Structure - Continued

#### Series B Financing

<table>
<thead>
<tr>
<th>Category</th>
<th>Shares</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>4,000,000</td>
<td>18.2%</td>
</tr>
<tr>
<td>Old Option Pool</td>
<td>2,000,000</td>
<td>9.1%</td>
</tr>
<tr>
<td>Series A Preferred Stock</td>
<td>4,000,000</td>
<td>18.2%</td>
</tr>
<tr>
<td>Option Pool Increase</td>
<td>2,000,000</td>
<td>9.1%</td>
</tr>
<tr>
<td>Series B Preferred Stock</td>
<td>10,000,000</td>
<td>45.5%</td>
</tr>
</tbody>
</table>

**“Fully-Diluted”** 22,000,000 Shares

- “Pre-Money” is $12,000,000, so . . .
- Series B Price = $12.0MM/12.0MM = $1.00 per Share
- $10,000,000 Investment (at $1.00) = 10,000,000 Shares
- “Post-Money” is $22,000,000
- “10 on 12” Round
Term Sheet Provisions

**LIQUIDATION PREFERENCE**

- Multiples (1x, 2x) Before Payment to Junior Classes
- “Participating” vs. “Non-Participating”
- “Senior” vs. “Pari Passu”

*Defined:* Right of Preferred Stock to Receive a Preferential Payout Relative to Other Stockholders Upon a Liquidation or Sale of the Company.
Examples of Liquidation Preference

<table>
<thead>
<tr>
<th>Class</th>
<th>Shares</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders</td>
<td>4,000,000</td>
<td>18.2%</td>
</tr>
<tr>
<td>Old Option Pool</td>
<td>2,000,000</td>
<td>9.1%</td>
</tr>
<tr>
<td>Series A Preferred Stock</td>
<td>4,000,000</td>
<td>18.2%</td>
</tr>
<tr>
<td>Option Pool Increase</td>
<td>2,000,000</td>
<td>9.1%</td>
</tr>
<tr>
<td>Series B Preferred Stock</td>
<td>10,000,000</td>
<td>45.5%</td>
</tr>
<tr>
<td><strong>“Fully-Diluted”</strong></td>
<td><strong>22,000,000</strong></td>
<td><strong>50.0%</strong></td>
</tr>
</tbody>
</table>

Participating Preferred/Series B Senior to Series A

- Sale $20 Million
- Series B → First $10MM
- Series A → Next $2MM
- All Shares → Split $8MM ($0.364/Share)

Non-Participating Preferred/Series B Senior to Series A

- Series B → First $10MM ($1.00 > $0.909)
- Series A/Founders/Options → Split $10MM ($0.83/Share)
  -(Series A Does Not Convert Because $0.83 > $0.50)
**Term Sheet Provisions**

**ANTI-DILUTION**

- Applies to “Down Rounds” Only
- “Full-Ratchet” vs. “Weighted Average”
- “Broad-based” vs. “Narrow-based”
- Exclusions and Carveouts

**Defined:** Adjustment to the Conversion Ratio of Preferred Stock into Common Stock Applied Upon the Subsequent Sale of Stock at a Lower Price than Current Round
Term Sheet Provisions

COMPOSITION OF BOARD OF DIRECTORS

- Size of Board
- Mechanics of Stockholder Voting
- Control Issues
- Voting Agreement
Term Sheet Provisions

DRAG ALONG RIGHTS

- Enforceability Issues
- Compromises
- Minimum Sales Prices

Defined: Right to Force Other Stockholders to Agree to a Sale of the Company
Term Sheet Provisions

**PROTECTIVE COVENANTS**

- Future Financings
- Changes in Rights, Preferences and Privileges
- Company Sale
- Board Composition
- Stock Option Plan Reserves
- Material Transactions

*Defined: Right to Prevent the Company from Taking Certain Actions Without Approval of the Investors*
Term Sheet Provisions

**INFORMATION RIGHTS**

- Information Rights
- Observation Rights
- Inspection Rights

*Defined: Right to Receive Information*
Term Sheet Provisions

REGISTRATION RIGHTS

- “Demand” Registration Rights
- “Piggyback” Registration Rights
- “S-3” Registration Rights

Defined: Rights to Cause the Company to Register the Shares Held by Investors with the SEC for Re-Sale to the Public
Term Sheet Provisions

**PARTICIPATION RIGHTS**

- Sometimes Limited to “Major Investors”
- Calculation of “Pro Rata Share”
- Carveouts and Exclusions
- Waiver of Rights

*Defined: Right of the Investors to Purchase a Pro Rata Share of Future Financings*
Term Sheet Provisions

**RIGHTS OF FIRST REFUSAL AND CO-SALE**

- Inhibits Founder Liquidity/Secondary Sales
- Carveouts and Exclusions
- Cumbersome Process

*Defined: Right of Investors to Purchase Shares to be Sold by a Company “Founder” or to Sell Shares in lieu of the Founder*
Term Sheet Provisions

OTHER ISSUES

• Drafting Control
• Pre-Closing Covenants (Diligence Issues)
• Post-Closing Covenants
• Legal Opinions
• Due Diligence and Legal Expenses
• Tranches based on Milestones
The Financing Process

Step One:

**PREPARATION**

- Forming and Organizing a Corporation
- Management Team
- Board of Directors
- Board of Advisors
- Assigning the Intellectual Property
- “Clean” is Better than “Complex”
The Financing Process

Step Two:

**BUSINESS DESCRIPTION**
(SOMETIMES STEP ONE)

- Understand the Business Model
- Test the Model
- Describe the Model
- Understand the Competition
- Business Plan, Executive Summary, PowerPoint
The Financing Process

Step Three: SHOPPING THE COMPANY

• Due Diligence on Potential Investors
• Creating a “Buzz”
• Identifying a Lead Investor
• Forming a Syndicate
The Financing Process

Step Four:

**BUSINESS DUE DILIGENCE**

- Defending the Business Model
- Educating the Investor
- Key References
- Management Diligence
The Financing Process

Step Five:

TERM SHEET

- Valuation
- Key Terms
- Understand Which Terms are Negotiable
- Spend the Time to Get the Terms Right
The Financing Process

Step Six:

LEGAL DUE DILIGENCE

• Capital Structure
• Stock and Option Vesting
• Employment and Consulting Agreements
• Key Contracts
• Intellectual Property
The Financing Process

Step Seven:

DEAL DOCUMENTS

- Preferred Stock Purchase Agreement
- Certificate of Incorporation
- Investor Rights Agreement
- Voting Agreement
- Right of First Refusal and Co-Sale Agreement
- Legal Opinion
- Ancillary Documents
The Financing Process

Step Eight: THE CLOSING

- Collecting Signatures
- Addressing Diligence Concerns and Issues
- Show Me the Money
The Financing Process

Step Nine:

AFTER THE CLOSING

• Closing Documents and Certificates
• Schedule First Board Meeting
• Meet Milestones
• Periodic Investor Updates
George Colindres is senior counsel with the Corporate practice and Emerging Companies & Venture Capital practice in the firm’s Los Angeles and San Diego offices. He acts as outside general counsel for clients in a diverse array of industries, including social networking, e-commerce, online advertising, online gaming, software, hardware, telecommunications, medical devices, biotechnology, pharmaceuticals and real estate. His work for these clients includes:

- Corporate governance, including entity formation and capital structuring and equity incentive plan matters
- Commercial and licensing agreements, including drafting and negotiating confidentiality/nondisclosure, clinical trial, distribution, development, manufacturing, VAR and OEM 2nd co-marketing agreements, terms of service/use and privacy policies
- Employment and compensation matters
- Preferred Stock and other equity financings
- Convertible promissory note (bridge) financings
- Venture debt financings and other secured transactions
- M&A transactions
- Public offerings

George also represents venture capital firms, private equity firms, real estate funds, strategic investors, angels and angel groups and other investors in connection with fund formation, governance matters, making investments and M&A transactions.
Emerging Companies & Venture Capital

Practice Spotlight

OVERVIEW

Perkins Coie’s Emerging Companies & Venture Capital group offers a wide breadth of experience in corporate and transactional matters. We have the depth and breadth of expertise and resources to scale with companies as they grow and to help them succeed over the long term. We take a pragmatic and solution-oriented approach, both in deals such as equity financings and other strategic transactions, and in our outside general counsel role, and we know how to get things done while striking the right balance between advocacy and compromise.

NOTEWORTHY PARTNERSHIP

We are trusted thought leaders. For years, lawyers in our practice have been members of the NVCA Model Legal Documents Working Group.

We not only helped developed model financing documents, but also served on the NVCA steering committee to develop model H.R. documents and codes of conduct for both the venture investors and the portfolio companies they invest in. We hope these policies are adopted throughout the industry, sending a strong message that sexual harassment and inappropriate behavior has no place in the venture eco-system.
Emerging Companies & Venture Capital

Practice Spotlight

With one of the nation’s largest and most active technology-oriented business practices, we have unmatched experience in handling complex corporate finance, intellectual property, technology transfer and other business issues on behalf of innovative startups and investors.

**STARTUP COUNSEL FOCUS AREAS**

- Formations and founder issues
- Independent contractor issues
- Privacy and security issues
- Crisis management
- Venture capital fund formation
- Venture capital litigation
- Dispute counseling
- Venture debt
- Corporate finance
- Initial public offerings
- General business counseling
- Intellectual property protection
- Corporate governance and advisor counseling
- Commercial contracts
- Mergers & Acquisitions
- Employee issues
- Licensing and technology
We have represented Amazon from its early days as a startup and served as counsel in its initial public offering. We continue to represent Amazon in numerous matters today. One example of our corporate venture capital work is our representation of Amazon in its formation of the Alexa Fund in 2015, and in its more than 30 investments in voice recognition startups. Amazon is investing in these startups to develop apps that will use the Alexa/Echo platform.
<table>
<thead>
<tr>
<th>Client</th>
<th>Represented</th>
</tr>
</thead>
<tbody>
<tr>
<td>McKesson</td>
<td>McKesson Ventures in its Series B Preferred Stock investment in a digital healthcare startup.</td>
</tr>
<tr>
<td>Microsoft</td>
<td>Represented Microsoft Corporation in its investments in Foursquare Labs, Inc. and more than 25 other emerging growth companies.</td>
</tr>
<tr>
<td>Blucora</td>
<td>Represented Blucora, Inc. in its preferred equity strategic investment in Series C Preferred Units in ValueAppeal.</td>
</tr>
<tr>
<td>First Data</td>
<td>Represented First Data Corporation in its preferred equity investments in Mineral Tree and Booker Software.</td>
</tr>
<tr>
<td>Confidential Client</td>
<td>Represented a confidential online retailer in its Series A investment in a food delivery company.</td>
</tr>
<tr>
<td>Lattice Semiconductor</td>
<td>Represented Lattice Semiconductor Corporation in a Series A Preferred Stock investment in Tactual Labs Co.</td>
</tr>
</tbody>
</table>
REGISTERED INVESTMENT COMPANIES

We have extensive experience representing registered investment companies, including open-end funds and closed-end funds, as well as BDCs. We routinely represent funds, their investment advisers or their independent board members. We also have the kind of contacts at the SEC and in the investment management industry that allow us to practice at the cutting edge of current developments. One hopes it will never be useful, but each of us has had substantial experience with SEC examinations and, unfortunately, with SEC enforcement cases involving participants in the investment management industry.

Perkins Coie lawyers advise major fund complexes in a variety of matters such as:

- Fund formation and registration
- Regulatory compliance
- Risk management
- Corporate governance
- Fund mergers and acquisitions
- Obtaining exemptive orders, no-action letters and other relief from regulatory agencies
- Negotiating and structuring investments
- Alternative investment strategy compliance
- Family offices
- Open-end and closed-end funds of all sizes
- Investment advisers
- Independent trustees
- Private equity funds
- Funds of hedge funds
- Offshore subsidiaries
- Borrowing facilities
- Derivatives
- Venture capital funds
- Hedge funds
- Real estate funds
- Search funds
- Distressed funds
Emerging Companies & Venture Capital

Key Differentiators

**COLLABORATIVE TEAM**

We have a deep and strong command of the corporate aspects and needs of startups and investors and, because of our depth and breadth, are able to engage specialists in key areas such as privacy and security and IP, at a moment’s notice.

**TRUSTED COUNSEL**

Our lawyers inspire deep confidence in clients that any deal we handle will result in efficient legal project management without any issue being overlooked. Clients appreciate and trust our impeccable judgment and intellectual approach.

**INDUSTRY FOCUS**

We represent VC funds and high-growth, VC-backed companies in fast-moving industry sectors and know that seasoned capabilities, coupled with a deep understanding of the inner-workings of our clients’ businesses, constitutes the basis for valuable service.

**THOUGHT LEADERSHIP**

We have one of the nation’s largest and most active technology-oriented business practices with an in-depth focus on emerging technologies, such as wearables, Internet of Things, blockchain technology, unmanned vehicles and virtual reality.
Corporate Practice Bench and Reputation

Practice Spotlight

- **300+** Corporate Lawyers
- **150+** M&A Lawyers
- **50+** Capital Markets Lawyers
- **50+** Startups & Venture Capital Lawyers

**Recognitions:**

- **IFLR 1000**
  - Ranked Nationally for Corporate and M&A Law

- **The Legal 500**
  - Recommended by Legal500 for Mergers & Acquisitions
  - Legal500 (2018)

- **US News–Best Lawyers®**
  - Ranked Tier 1 for Corporate Law, Venture Capital, and Securities Law

- **Chambers USA**
  - Ranked Nationally for Startups & Venture Capital Law
  - *Chambers USA* (2018)

- **JD Journal**
  - Named the Go-To BigLaw Firm for Silicon Valley Entrepreneurs

- **Inc.**
  - Named a Top 4 Law Firm in Silicon Valley by Tech Entrepreneurs

- **BTI Brand Elite**
  - Named a “Leader” Among Tech-savvy Law Firms
  - BTI Brand Elite (2016)

- **NYSE Governance Services**
  - Named a Top 20 Corporate Law Firm in the United States
  - NYSE Governance Services (2015)
Emerging Companies & Venture Capital
Representative Investor Clients
Emerging Companies & Venture Capital

Representative Investment Counsel Experience

BCV
Banhamo Global Ventures, LLC
Investment in InterDigital

BD&A
Bassam, Deustch & Associates, Inc.
Committee Equity Investment and Recognition by American Capital Ltd.

DCP
DCP Capital Partners
Re-financing of Hotel "Seats", Denver

EnhancedCapital
Enhanced Credit Supported Loan Fund, LP
Investment in Buxly

First Data
First Data Corporation
Preferred Stock Investment in Boker Software, Inc.

Javelin Venture Partners
Javelin Venture Partners
Investment in Jokiu, Inc.

Madrona Venture Group
Madrona Venture Group, LLC
Preferred Stock Investment in Emerg VR

Microsoft
Microsoft Corporation
Saves Omnisolr.com

Pylon Capital
Pylon Capital LLC
Sale of Insight Market, LLC

Second Avenue Partners
Second Avenue Partners
Investment in Cowork, Inc.

Simple Finance Technology
Simple Finance Technology
Preferred Stock Financing

Voyager Capital
Voyager Capital

WestRiver Management, LLC
WestRiver Management, LLC
Formation of WestRiver Equity Partners, LLC

Vulcan Capital Growth Equity LLC
Vulcan Capital Growth Equity LLC
Investment in TrueCar, Inc.
PERKINS COIE ANGEL NETWORK

We created the Perkins Coie Angel Network to help our seed-stage clients get access to a broad angel community. Our proprietary network allows us to efficiently profile active angel investors seeking startup deal flow. We leverage those profiles to connect our startup clients with angels and seed investors who meet their investment criteria.

LE[A]DBETTER

We know that capital is the primary catalyst for business growth. To help women business leaders maximize their company’s capital, we are offering qualifying startups that have at least one woman in a senior leadership role a 15% discount off of our standard hourly rates for certain legal services for a limited period of time. We also provide opportunities for leaders to learn and network with startup ecosystem luminaries to help drive business growth.

STARTUPPERCOLATOR.COM

In 2012, we launched Startup Percolator, a user-friendly interactive website that enables entrepreneurs to generate the legal documents needed to form a Delaware "C" corporation, free of charge. Startup Percolator also includes a blog with rich, dynamic content and helpful tips to guide companies through the start-up process.
AT PERKINS COIE, WE ARE BUILDING THE NEXT-GENERATION TOOLS AND SERVICES TO HELP OUR STARTUP CLIENTS EXPERIENCE GROWTH AS THEY BUILD GREAT COMPANIES.

Our Startup & Investor Services team combines decades of experience with the power of Perkins Coie’s network to provide entrepreneurs the resources required to navigate the ever-changing landscape.

VC DEAL FUNNEL

CAPITAL IS NOT ONE-SIZE-FIT-ALL

Our team works to prepare our clients for the process of raising capital and helps them target the right investors. Our goal is to create win-win relationships for our clients and investors.

SYSTEMATIC APPROACH TO RAISING CAPITAL

We work with the client before their plan is sent to investors to optimize their fundraising potential. Our group advises clients on these key components:
To help make gender equality in business leadership a reality, Perkins Coie proudly launches Le[a]dBetter, an innovative program that supports startups that have women in senior executive roles. Inspired by the Lilly Ledbetter Fair Pay Act of 2009, legislation drafted in response to the Lilly Ledbetter gender wage gap lawsuit, Le[a]dBetter is an innovative educational, networking and alternative fee arrangement program designed to offer support to companies in the startup ecosystem that demonstrate inclusion and business leadership diversity in their executive suite.

We are offering qualifying startups that have at least one woman in a senior leadership role a 15% discount off of our standard hourly rates for certain legal services for a limited period of time. We also offer investors who invest in startups with at least one woman in a senior leadership role a 15% discount off of our hour rates.

To round out the Le[a]dBetter program, we are also providing participants with access to:

- educational seminars developed to help women executives further enhance their leadership and business skills; and
- ongoing opportunities to network with other business leaders.

Women entrepreneurs are majority owners of an estimated 10 million businesses, or, as currently reported by the U.S. Small Business Administration, 36% of all businesses in the United States. Yet, in the U.S., of the 1,186 companies that received Series A funding in 2015, just 6.6% - 79 companies - included a woman on the founding team. - PitchBook
To learn more, visit www.perkinscoie.com.