Venture Capital Deals, Documents and Terms

Introduction

So you have pitched your company to investors, had many meetings, now what? If you have a VC investor who wants to do a deal attention will turn to the process by which an investment will be negotiated and agreed.

This process can be characterised by the documents in which it is captured. This short briefing outlines these documents, their purpose and common terms used within them.

The First Document – The Term Sheet

The term sheet outlines the key financial and other terms of a proposed investment. These include, inter alia: the amount of money to be invested, the financial instruments to be used, and the valuation being placed on the company. Once agreed by all parties, the Term Sheet is used as a basis for drafting the investment documents. Provisions of a Term Sheet are not usually legally binding (with the exception of certain clauses – such as confidentiality, exclusivity and costs). The Terms of the investment will usually be conditional upon the successful completion of financial, technical and commercial due diligence.

Subsequent Investment Documents

The principal documents needed for an investment round are:

> **Subscription Agreement** - usually contain details of the investment round, including number and class of shares subscribed for, payment terms, milestones and representations and warranties about the condition of the company. These representations and warranties will be qualified by a disclosure letter and supporting documents that specifically set out any issues that the founders believe the investors should know prior to the completion of the investment.
>
> **Shareholders' or Investors' Rights Agreement** - will usually contain investor protections, including consent rights, rights to board representation and non-compete restrictions. The provisions in this Agreement will hopefully be used as the basis for corresponding provisions on subsequent funding rounds.
>
> **Articles of Association** - will include the rights attaching to the various share classes, the procedures for the issue and transfer of shares and the holding of shareholder and board meetings. Some of the protective provisions in the

Shareholders' Agreement may instead be contained (or indeed) repeated in the Articles of Association. The decision to include terms in one or both of these documents can have confidentiality implications (among other considerations) - Articles of Association typically must be filed as a public document with a relevant company registry while the other investment documents can often be kept confidential.

The Common Terms

Type of Share – VC's will almost always want preference shares which have certain rights attached that ordinary shares don't have. If preference shares already exist (say from a previous investment round) usually a new class of preference share will be created. The rights enjoyed by the various classes of preference shares tend to reflect the stage of investment and its risk profile. These additional rights are to protect the investor and typically include:

- **Dividend rights** – usually VC's prefer profits to be reinvested to create value at exit rather than paid out as dividends to shareholders, therefore sometimes there is a prohibition on payment of any dividends.

- **Liquidation rights** – confers special rights in the event of liquidation for the investor to receive an amount of the proceeds before anyone else.

- **Redemption rights** – the right to demand the company buys back its shares from the investor at a fixed price under certain conditions.

- **Conversion rights** – the right of the investor to convert preference shares to ordinary shares (often at any time). Normally delayed until exit or IPO.

- **Voting rights** – preferred shares may have equivalent voting rights to ordinary shares in a general meeting, though it is also possible that they may carry more than one vote per share under certain circumstances.

Valuation – The valuation agreed by both parties following negotiation is the **pre money valuation** and this is used to calculate the **purchase price** of the shares. The pre money valuation should be distinguished from **the post money valuation** which refers to the valuation of the company immediately after the investment has been made and includes that investment.

Milestones – Quite often, VC investors will invest in **tranches**, subject to various technical and/or commercial targets (milestones) being met. Failure to meet a milestone may mean that they will seek to negotiate different terms for the additional money. Sometimes a mechanism, a **ratchet** is used to adjust the respective shareholdings of the investors and the founders depending on either the company's performance or the level of returns on an exit (**exit ratchet**). This technique is principally to provide additional incentives/rewards to the founders for delivering excellent returns to the investors. Ratchets can be complicated in operation and need to be very carefully thought through due to tax issues and in order to avoid conflicts of interest at a later date.

Anti-dilution Rights – These rights protect the value of the VCs stake in the company if new shares are issued at a valuation which is lower than that at which they originally invested (a **down round**). This protection gives a number of new shares which the investors will receive, for no or minimal cost, to offset the dilutive effect of the issue of cheaper shares.

Founder Shares - Founders and key managers who leave the company within a certain period of time may be required to sell their shares back to the company or to other shareholders. The price paid for the shares may depend upon circumstances of departure – it may be at market value if the person is deemed to be a **good leaver**, or it might be considerably less in the case of a **bad leaver** (for example where someone has breached their contract of employment).

Pre-emption Rights - Where the company issues new shares, a VC investor will require the right to maintain at least its percentage stake in the company by participating in the new offering up to the amount of its pro rata holding, under the same terms and conditions as other participating investors. Pre-emption rights are automatically provided under UK law.

Tag Along and Drag Along Rights – If the shares being purchased are the subject of a tag along right the other shareholders who benefit from the right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. This may have the effect of making the shares more difficult to sell. A drag along provision creates an obligation on all shareholders to sell their shares to a potential purchaser if a certain percentage of the shareholders (or of a specific class of shareholders) votes to sell to that purchaser. These rights can be useful in the context of a sale where potential purchasers will want to acquire 100% of the shares of the company in order to avoid having responsibilities to minority shareholders after the acquisition.

Warranties – These ensure the investors are provided with a complete and accurate understanding of the current condition of the company and its past history so that they can evaluate the risks prior to investing. The warrantors have the opportunity to set out issues which ought to be brought to the attention of the new investors via the **disclosure letter** or **schedule of exceptions**. This discloses detailed information concerning any exceptions to or carve-outs from the representations and warranties (e.g. specific company assets, contracts, shareholders, employees, etc.). If a matter is referred to in the disclosure letter the investors are deemed to have notice of it and will not be able to claim for breach of warranty in respect of that matter.

Board of Directors – In accordance with best practice, investors usually prefer the Board to have a majority of **non-executive directors** (i.e. directors who are not employees of the company). Although a majority of non-executives may be impractical for small companies, it is usual for such companies to have at least one or two non-executives. One or more of the non-executive directors will be appointed by the investors under rights granted to them in the investment documentation. Some investors will never appoint a director, because of potential conflicts of interest and liability issues and will instead require the right to appoint a **Board Observer**, who can attend all board meetings, but who will not participate in any board decisions.

Information Rights – Require the company to provide investors with certain regular update concerning its financial condition and budgets, as well as a general right to visit the company and examine its books and records.

Management Non Compete Agreements - If the management team and founders were to leave the company to create or work for a competitor, this could significantly affect the company's value. Investors normally require that Non-compete Agreements be included in the Investment Agreement as well as in the Employment/Consultancy Agreements, to enable them to have a right of direct action against the founders and managers if the restrictions are breached.

Employee share option scheme - Investors typically want 10%-20% of the share capital of the company to be reserved in an option pool. The company will then be able to issue the shares under the plan without requiring further approval.
Fees – These usually consist of a **transaction fee** to cover costs incurred in connection with the investment process, plus an annual **monitoring fee** to compensate for the level of involvement with the company.

Exclusivity - Once a Term Sheet is signed, VC investors will undertake various types of **due diligence**, a process that can take several weeks or even months and the will involve expense. The investors will not want to discover that while they are incurring this expense the company accepts investment from other investors. To protect themselves, some investors will ask for an exclusivity period during which the company is prohibited from seeking investment from any third parties. A breach of this obligation will result in the company and founders incurring a financial penalty.

Conditions Precedent - A full list of conditions to be satisfied before investment will be included in the Term Sheet. A VC investment will usually be conditional on not only the negotiation of definitive legal documents, but also the satisfactory completion of due diligence and approval by the Investment Committee of the VC investors. Other examples include confirming the tax status with HM Customs & Revenue and putting contracts in place with key employees.

In Practice

- Once agreed by all parties, lawyers use the Term Sheet as a basis for drafting the subsequent investment documents. The more detailed the Term Sheet, hopefully the fewer the issues which will need to be agreed during the drafting process.
- Subscription and Shareholders Agreements are often combined into a single "Subscription and Shareholders' Agreement" or Investment Agreement.
- The process can be complex and working with lawyers who are familiar with VC transactions is recommended in order to minimise timeframe and costs.
- Ideally a company will seek several term sheet offers before deciding which they will sign up to and therefore which investor they will give exclusivity.
- By law, Directors appointed by investors have a responsibility to act in the interest of the company rather than as a representative of the funds that they manage. Often VC's separate the investment decisions for the funds invested in the companies from the investor director's decisions in order to avoid conflicts of interests for the investor director. This is typically done by having another investment executive representing the funds' interests when dealing with the company with respect to the Investor consent matters.
- Confidentiality - All exchanges of confidential information between potential VC investors and the company need to be subject to a Confidentiality Agreement. This agreement should be executed as soon as discussions with the company about a potential investment begin. If not, then a confidentiality restriction should be included in the Term Sheet.

References and Useful Contacts:

The British Venture Capital Association (BVCA) has a fully detailed description and explanation of the term sheet and other documents as well as a glossary of VC terms available at www.bvca.com.