“Papering the Deal”: The Basics of Term Sheets and Other Documentation in Private Equity Transactions

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Introduction

The term sheet is the first step in the process leading to definitive agreements that will reflect the terms of the venture capital or other private equity transaction. A term sheet is the “agreement to agree” on the main points of a deal. There is always a tension in the preparation of the term sheet between whether to have a tightly negotiated, detailed term sheet, with most of the terms explicitly spelled out, or to have a more generalized term sheet, with the understanding that significant terms will continue to be negotiated during the due diligence process. The former approach can make drafting the definitive documents easier because the parties have spelled out the specific terms of the transaction, although it may be more difficult to re-negotiate key terms as the parties go through the process of conducting due diligence and documenting the transaction, even though not all provisions in a term sheet are binding. On the other hand, a simpler term sheet requires that more effort be expended during the final documentation phase of the transaction, but gives the parties more room to maneuver (and possibly re-trade) before the definitive documents are completed.

Binding Provisions

There are usually only a few parts of a term sheet that are intended to be legally binding, usually relating to confidentiality and “No Shop” provisions.

Confidentiality

Because the company will have to provide detailed information to the potential investors regarding the company and its operations in order for the private equity firm to evaluate the investment, confidentiality provisions protect the company’s sensitive information from disclosure by the potential investor to third parties. Potential investors may be reluctant to sign overly comprehensive or restrictive non-disclosure agreements because the nature of their business puts them in contact with many other companies. Nonetheless, the founder of the company has every right to expect a confidentiality provision, particularly by the time the parties reach the term sheet stage.

“No-Shop” Provisions

A “No-Shop” provision prohibits the company from exploring alternate financing with any third party for a specified length of time. Potential investors understandably do not want to spend the time and money involved in conducting due diligence and negotiating documentation, only to find that the company is exploring a transaction with another investor. Consequently, an entrepreneur with more than one interested investor should be cautious before entering into this type of provision, given that negotiating on the side with another party would be a breach of the

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term sheet. In addition, the company should try to avoid no-shop provisions that are too restrictive or extend for too long a period of time, particularly if the company’s need for the financing is immediate.

**Basic Provisions in the Equity Financing Term Sheet**

**Type and Price of the Security; Valuation; Capitalization**

One of the initial deal terms that must be determined is the type of security (common stock, preferred stock, warrants, etc.) and the per share price of the security. Most venture capital investors make their investments in the form of preferred stock, rather than common stock, because the features of preferred stock discussed below make preferred stock a more attractive investment. The price per share will be based on the capitalization and valuation of the company.

The valuation and capitalization sections of the term sheet specify the pre-money and post-money valuations of the company, based on the number of shares of stock of the various classes (common and preferred) that are outstanding before the financing and that will be outstanding after the financing. Investors analyze their investment in a company based on the capitalization of the company on an “as-converted” basis. As-converted means that the capitalization is based on the total number of shares actually outstanding, plus all of the shares that would be outstanding if options and warrants were exercised and convertible securities were converted. The percentage acquired by the investor, along with the shares that are generally allocated to pool of options to provide incentive to attract and retain good talent, has the ultimate effect of diluting the founder’s share of the company, thereby reducing the founder’s proceeds in a liquidity event.

In later stage companies that have undergone a prior venture capital financing, the terms of the second series of preferred stock may differ significantly from the prior round of financing. The later stage investors will want the terms of their stock to be at least as favorable, if not more favorable, than the terms of the earlier transaction. The early round investors, on the other hand, may object to such favorable terms under the rationale that their investment was more at risk at during the earlier stages of the company. Pricing and other terms of a later stage deal will hinge largely on the Company’s bargaining position, how successful it has been, how urgent the need for the financing is and general market conditions.

**Dividends**

Although most early and middle stage companies rarely pay dividends, the dividend features of the preferred stock will nonetheless affect how the proceeds from a sale of the company will be distributed, particularly how much of the sales price is available for payment to the holders of common stock, including the founder and holders of stock options. Most investors prefer cumulative dividends, which means that, although dividends are unlikely to be paid, they continue to accumulate and will be taken into account when calculating how much common stock into which the preferred stock will be converted upon a sale or other disposition of company’s stock, since the unpaid dividends are added to the liquidation preference the holders of preferred stock will receive in a sale.
Liquidation Preferences

Holders of preferred stock will receive a preference on distributions in the event of a liquidation or winding up of the company. Preferred stock terms generally provide that events such as a sale or merger of the company are “deemed” liquidations, thereby triggering the preference. The liquidation preference will be paid to preferred shareholders prior to any payment to holders of other classes of stock. In situations where there are multiple series of preferred stock, there may be very little left to pay the holders of common stock upon a sale of the company. On the other hand, if the company has become successful enough to go be sold or go public, it may very well have been the investor’s financing that provided the necessary growth capital for the company to reach that point.

Liquidation preferences are typically equal to the amount invested, but, depending on the nature of the deal, can be a multiple of the amount invested. During cycles in which it is a buyer’s market for the private equity investor, the multiple requested might be as much as three to five times (or more) of the amount invested. Consequently, the entrepreneur should take liquidation preferences into careful consideration. If a company is valued too low for purposes of a liquidity event, the proceeds to the holders of common stock can be significantly diminished by the time the various liquidation preferences are paid.

Once the liquidation preference is paid, the holders of common stock share the remaining proceeds according to their respective ownership positions. If the preferred stock is “participating preferred,” the preferred stock and the common stock will share the balance of the sale proceeds pro rata, on an as-converted basis, further decreasing the proceeds to the holders of common stock.

Conversion Provisions

Conversion rights give the investor the optional right to convert its preferred stock to common stock. Under normal circumstances, investors rarely do this as there is no financial incentive to do so, because common stock in a private company typically has limited real value in the absence of a liquidity event. Consequently, the investor will generally convert the preferred stock just prior to a sale or merger. In the event of an initial public offering, conversion of the preferred stock is usually automatic, because underwriters of a public offering rarely, if ever, will take a company public with multiple classes of stock. The investor will generally specify the minimum size of a public offering of the company’s stock to ensure the expected rate of return on the original investment.


Holders of preferred stock will generally have equal voting rights as the common stock, voting on an as-converted basis, which will typically give them a greater percentage of the company for voting purposes and, therefore, a greater influence on significant corporate decisions. The founder should pay close attention to the post-investment, as-converted capitalization of the company in determining what the voting dynamics will be. The investor will be given certain approval or outright veto rights (called “protective provisions” or “negative
covenants”) for events such as mergers, acquisitions, a sale of the company’s assets, a public offering, dividends, redemptions, additional issuances of securities and the like. These protective provisions typically require the approval of the holders of at least a majority, or in some cases, a supermajority, of the preferred stock, voting as a separate class.

It is usually important to the founder that the investor is not given too much power to control the company’s day to day operations. At the same time, it is reasonable for an investor to have some control over actions that significantly affect the investment and the nature and timing of any liquidity event. The personality of the individuals and the investment style of the private equity firm will be a factor. Some firms may want a more hands-on involvement in a portfolio company’s operations, while others with confidence in the company’s management team will take a more supervisory approach.

**Board of Directors; Information Rights**

The equity investor will almost always want representation on the board of directors. The nature of the financing and the bargaining strength of the parties will determine whether the investor group will want to place only one director (or perhaps only an observer) on the board, or is in a position to demand a majority of the board seats. In some investments, the private equity group may initially begin with only one or two board seats, but can “flip” the board and obtain a majority of the board seats if certain mileposts are not achieved or certain negative events occur.

The structure and composition of the board should be carefully considered, as the founder and upper management will have to deal with the board with respect to any major corporate decisions. Most often, a board representative from the investor group can give excellent guidance, particularly if the group has industry-specific experience. On the other hand, personalities will also influence the dynamics of this working relationship, so it is important to feel comfortable with the representatives the investor intends to select as board members.

In addition to director seats, the investor will require that the company provide it with certain “information rights.” These are generally annual and quarterly financial reports, projections and budgets. The level of detail and time frames for required delivery of the information will vary transaction by transaction.

**Redemption**

Some term sheets call for a redemption provision, which provides the investor with liquidity by requiring the company to buy back the shares when it has the financial wherewithal to do so. Redemption will generally only be considered when the company has become profitable but there are no opportunities for liquidity through a sale, public offering or a recapitalization.

**Antidilution Provisions**

Antidilution (or “price protection”) provisions protect the private equity investor if the company sells additional shares of stock in a subsequent financing at a price below the per-share price the original investors paid. Initially, preferred shares will convert to common shares on a
one to one basis. If additional shares are later sold at a lower price, the conversion price of all the shares purchased at a higher price will be adjusted downward, with a corresponding maintenance (or only slight decrease) in the percentage of the company owned by the earlier investors. As a result, previous investors will gain more shares and holders of common stock or other series of preferred stock, the terms of which do not include price protection, will be diluted.

There are two main types of antidilution mechanisms provisions typically found in equity financings: the “weighted average” adjustment, which is a formula that takes into account the amount of new shares to be sold and the amount of additional money being raised to determine the number of new shares to be issued and the conversion ratio adjustment. The “full ratchet” is a more severe form of antidilution provision, requiring that the price of the preferred shares sold to the prior investors must be reduced to match the conversion price of the shares sold in the later financing. The full ratchet has a significantly more dilutive effect on the other classes of the company’s stock. The type of ratchet negotiated is highly dependent on overall market conditions and the company’s financial situation.

Transfer Restrictions; Preemptive Rights; Rights of First Refusal; Tag-Along and Drag-Along Provisions

Transfer Restrictions. Most investors, and many companies, will require that the shares of the company, whether owned by the founder or the investors, are subject to restrictions on their transferability. These provisions are useful to ensure that the company’s shares are not transferred to persons that the company does not wish to have as a shareholder, such as a competitor or a disgruntled spouse. In some cases all transfers are prohibited. In most cases, a founder or shareholder wishing to dispose of shares will be subject to the various types of rights described below. It is not uncommon, however, to make exceptions for transfers to family members, trusts and the like for purposes of estate planning, but the transferee of the shares will be subject to the same transfer restrictions.

Preemptive Rights. Preemptive rights give the existing shareholders (usually only the preferred investor) a right to purchase a portion of any new securities issued by the company (as opposed to shares being sold by a founder or shareholder). Like many provisions in the term sheet, this provision is designed to enable the investor to retain its relative percentage of the total shares outstanding. Preemptive rights do not, however, give the investor any preferential provisions or pricing.

Rights of First Refusal; Tag-Along and Drag-Along Provisions

First refusal rights require that if a founder or any other shareholder wishes to sell their shares, they must offer them first to the company and/or or the other preferred shareholders. Once the selling shareholder has gone through the first refusal process, if a sale to a third party moves forward, the other shareholders may have the right to “tag-along” on the sale by being offered the opportunity to sell a pro rata portion of their shares. Unfortunately, these provisions can make it harder for an insider to sell shares because the potential purchaser now has to deal with multiple sellers, and also have the practical effect of reducing the number of shares the insider is permitted to sell. If the number of shares the selling shareholder wishes to sell are
substantially cut back by this process, the selling shareholder may not find it worth the trouble to sell.

“Drag-along” provisions allow the investors holding a specified percentage of outstanding shares (usually at least a majority) that have identified a third party purchaser to require the other shareholders to participate in the sale. The provision is designed to allow a sale of the company even if not all of the shareholders are in favor of it, due to timing, pricing or other considerations. It thus makes it harder for a small group of shareholders to block a liquidity event.

Registration Rights

The registration rights provision gives the equity investor the right to force an initial public offering in order to sell its shares in an initial public offering or sell them later in a subsequent offering, thereby providing the investor with a liquidity event. In reality, these rights are seldom exercised, given the small number of companies that ever go public. In the case of those that do, the underwriters of a public offering will often require substantial changes to the registration rights granted.

Additional Provisions in the Leveraged Buyout or Recapitalization

General

In the context of a leveraged buyout or recapitalization, in addition to the terms of any new equity to be issued, such transactions will generally have a debt component, whereby the purchase of management’s stock and/or new equity will be financed, using the cash flow of the company to back the debt. In a management buyout, the management finances the purchase. In some cases, the funding may come from the company’s senior lender (or a new senior lender), while in others, the private equity group may take the senior loan position. Frequently, the private equity investor will take subordinate “mezzanine” debt, along with an “equity kicker,” such as warrants to purchase additional shares of the company at a reduced price at a later date. In the latter scenario, the mezzanine loan will be subordinate in payment to the senior loan and will traditionally have a longer term. The senior lender will generally not permit any payments on the subordinated debt until the senior loan is paid off.

The advantage to the founder and optionholders of a leveraged buyout or recapitalization is that it allows them to receive a substantial dividend, while continuing to retain ownership in the company (the amount will vary depending on the terms of the deal) and remain active in the management and future success of the business. At the same time, depending on the structure and amount of the financing, the company may also receive additional capital for further growth.

Earnouts

It is quite common in leveraged buyout or recapitalization transactions for the founder and other management shareholders to be required to defer a portion of their proceeds from the sale over a period of years, based upon specified performance targets, usually by reaching some level of profitability or based on a specified multiple of earnings. This reflects the investor’s
reasonable expectation that the management that has built the company to the point where a leveraged buyout or recapitalization is financially attractive will remain with the company to make sure the investment plays out over time to the investor’s satisfaction. The risk here lies squarely on the shoulders of the management team to produce the specified results. Consequently, earnout provisions should be very thoroughly and carefully negotiated. In addition, management must be prepared to remain with the company for the entire earnout period, since most earnouts are forfeited if the recipient leaves the company prior to the specified time. This can be easier said than done, depending on whether the private equity investor brings in new or additional management and the team doesn’t work well together, or the investor takes too active a management role or simply becomes meddlesome.

Additional Terms Relating to the Loan Component

Loan documents can be very complex and a detailed explanation of their terms is beyond the scope of this discussion. Typical loan documents (listed on Appendix A), whether they are executed between the company and the investor directly, or with a third party lender, will contain provisions relating to, among others things, the:

- principal amount of the loan;
- interest rate;
- terms of repayment/prepayment/penalties;
- collateral for the loan (generally all of the assets of the business, including cash flow);
- financial covenants that must be met;
- negative covenants (similar to those in the equity transaction);
- senior/subordinate nature of the loan;
- equity rights to be granted in connection with the loan (if any); and
- the lender’s rights on a default.

It is important to note that, in addition to the various things the company may be prohibited from doing under the terms of the equity portion of the transaction, the loan agreements will also have prohibitions on certain corporate actions. Consequently, management will be subject to significant restrictions in the way it runs the business and should make sure that the covenants are not so onerous as to prevent the company from operating day to day. With regard to financial covenants (maintaining a level of EBITDA, debt to earnings ratio, etc.), care should be taken that the covenants are not structured in a way that would put the company into default for minor deviations.

Conclusion

Negotiating and executing a term sheet are just the beginning steps in the process of developing the relationship between the company and the private equity investor. Private equity transactions are clearly an important factor in the growth and prosperity of the private enterprise and the ability of the founder and the management team to eventually reap the rewards of their
hard work. Although negotiating a term sheet and the definitive documents may seem like an adversarial process at times, generally the venture capitalist wants to work with the company and its founder toward a mutually satisfactory outcome. People are people, and business is business, however, and personalities, marketplace conditions (both present and anticipated), the stage of the company’s growth and earnings and the severity of need for financing will all come into play. The founder will be faced with making difficult decisions throughout the process, so it is imperative to have a good sense of the present and projected value of the company and the founder’s contributions to its growth and future success.
APPENDIX A

The following is a brief outline of the various documents that are used in the typical private equity deal, and incorporate the various items in the term sheet.

**Typical Equity Transaction Documents**
1. Certificate of Designation
2. Stock Purchase Agreement
3. Shareholder’s Agreement
4. Registration Rights Agreement
5. Employment Agreements; Non-compete; Non-solicitation Agreements

**Typical Leveraged Buyouts and Recapitalizations**
1. Loan agreements (senior; mezzanine)
2. Promissory Note(s)
3. Intercreditor Agreements
4. Security Agreement
5. UCC financing statements
6. Option Plan and grant agreements
7. Warrant (if mezzanine financing)
8. Personal Guaranty