CHAPTER 5

Control Terms of the Term Sheet

The terms we discussed in the preceding chapter define the economics of a deal; the next batch of terms define the control parameters of a deal. VCs care about control provisions in order to keep an eye on their investment as well as comply with certain federal tax statutes that are a result of the types of investors that invest in VC funds. While VCs often have less than 50 percent ownership of a company, they usually have a variety of control terms that effectively give them control of many activities of the company.

In this chapter we discuss the following terms: board of directors, protective provisions, drag-along rights, and conversion.

Board of Directors

One of the key control mechanisms is the process for electing the board of directors. The entrepreneur should think carefully about what the proper balance should be among investor, company, founder, and outside representation on the board.

The Entrepreneur's Perspective

Electing a board of directors is an important, and delicate, point. Your board is your inner sanctum, your strategic planning department, and your judge, jury, and executioner all at once. Some VCs are terrible board members, even if they're good investors and nice people.

A typical board of directors clause follows:

> Board of Directors: The size of the Company's Board of Directors shall be set at [X]. The Board shall initially be comprised of ______________, as the Investor representative[s] ______________, ______________, and ______________. At each meeting for the election of directors, the holders of the Series A Preferred, voting as a separate class, shall be entitled to elect [X] member[s] of the Company's Board of Directors which director shall be designated by Investor, the holders of Common Stock, voting as a separate class, shall be entitled to elect [X] member[s], and the remaining directors will be [Option 1: mutually agreed upon by the Common and Preferred, voting together as a single class] [or Option 2: chosen by the mutual consent of the Board of Directors].

If a subset of the board is being chosen by more than one constituency (e.g., two directors chosen by the investors, two by founders or common stockholders, and one by mutual consent), you should consider what is best: chosen by mutual consent of the board (one person, one vote) or voted upon on the basis of proportional share ownership on a common-as-converted basis.

VCs will often want to include a board observer as part of the agreement either instead of or in addition to an official member of the board. This is typical and usually helpful, as many VC partners have an associate who works with them on their companies.

The Entrepreneur's Perspective

Be wary of observers. Sometimes they add no value yet they do take up seats at the table. Often, it's not about who votes at a board meeting, but the discussion that occurs, so observers can sway the balance of a board. You don't want to find yourself with a pre-revenue company and 15 people around the table at a board meeting.

Many investors will mandate that one of the board members chosen by common stockholders be the then-serving CEO of the company. This can be tricky if the CEO is the same as one of the key founders (often you'll see language giving the right to a board seat to one of the founders and a separate board seat to the then CEO), consuming two of the common board seats. Then, if the CEO changes, so does that board seat.

Let's go through two examples: an early stage board for a company that has raised its first round of capital and the board of a company that is mature and contemplating an initial public offering (IPO).

In the case of the early stage board, there will typically be five board members:

1. Founder
2. CEO
3. VC
4. A second VC
5. An outside board member

This would be the default case for a balanced board that gives the VC enough influence to be comfortable without having control over the board. Correspondingly, the founder and CEO will have the same number of seats as the VCs, and the outside board member will be able to help resolve any conflicts that arise as well as be a legitimately nonconflicted board member.

In the case of a mature board, you'll typically see more board members (seven to nine) with more outside board members. The CEO and one of the founders are on this board along with a few of the VCs (depending on the amount of money raised). However, the majority of the additions to the board are outside board members, typically experienced entrepreneurs or executives in the domain in which the company is operating.

While it is appropriate for board members and observers to be reimbursed for their reasonable out-of-pocket costs for attending board meetings, we rarely see board members receive cash compensation for serving on the board of a private company. Outside board members are usually compensated with stock options—just like key employees—and are often invited to invest money in the company alongside the VCs.

Protective Provisions

The next key control term you will encounter in the term sheet is the *protective provisions*. Protective provisions are effectively veto rights that investors have on certain actions by the company. Not surprisingly, these provisions protect VCs, although unfortunately not from themselves.

The protective provisions are often hotly negotiated but over time have mostly become standardized. Entrepreneurs would like to see few or no protective provisions in their documents. In contrast, VCs would like to have some veto-level control over a set of actions the company could take, especially when it impacts the VCs' economic position.

A typical protective provision clause looks as follows:

> Protective Provisions: For so long as any shares of Series A Preferred remain outstanding, consent of the holders of at least a majority of the Series A Preferred shall be required for any action, whether directly or through any merger, recapitalization, or similar event, that (i) alters or changes the rights, preferences, or privileges of the Series A Preferred; (ii) increases or decreases the authorized number of shares of Common or Preferred Stock; (iii) creates (by reclassification or otherwise) any new class or series of shares having rights, preferences, or privileges senior to or on a parity with the Series A Preferred; (iv) results in the redemption or repurchase of any shares of Common Stock (other than pursuant to equity incentive agreements with service providers giving the Company the right to repurchase shares upon the termination of services); (v) results in any merger, other corporate reorganization, sale of control, or any transaction in which all or substantially all of the assets of the Company are sold; (vi) amends or waives any provision of the Company's Certificate of Incorporation or Bylaws; (vii) increases or decreases the authorized size of the Company's Board of Directors; (viii) results in the payment or declaration of any dividend on any shares of Common or Preferred Stock; or (ix) results in issuance of debt in excess of $100,000.

Let's translate this into what the VC is trying to protect against. Simply, unless the VC agrees, don't:

- Change the terms of stock owned by the VC.
- Authorize the creation of more stock.
- Issue stock senior or equal to the VC's.
- Buy back any common stock.

- Sell the company.
- Change the certificate of incorporation or bylaws.
- Change the size of board of directors.
- Pay or declare a dividend.
- Borrow money.

Subsection (ix) of the protective provision clause is often the first thing that gets changed by raising the debt threshold to something higher, as long as the company is a real operating business rather than an early stage startup. Another easily accepted change is to add a minimum threshold of preferred shares outstanding for the protective provisions to apply, keeping the protective provisions from lingering on forever when the capital structure is changed—through either a positive or a negative event.

Many company counsels will ask for *materiality qualifiers*—for instance, that the word *material* or *materially* be inserted in front of subsections (i), (ii), and (vi) in the example. We always decline this request, not to be stubborn, but because we don't really know what *material* means (if you ask a judge or read any case law, that will not help you, either), and we believe that specificity is more important than debating reasonableness. Remember that these are protective provisions; they don't eliminate the ability to do these things, but simply require consent of the investors. As long as things are not material from the VC's point of view, the consent to do these things will be granted. We'd always rather be clear up front what the rules of engagement are rather than have a debate over what the word *material* means in the middle of a situation where these protective provisions might come into play.

The Entrepreneur's Perspective

As far as the example protective provision clause is concerned, (i) fair is fair; (ii) fair is fair; (iii) fair is fair; (iv) this should be positive for VCs, but not a big deal; (v) this is critical as long as Series A preferred holders represent, in aggregate, enough of your capitalization table to be relevant; (vi) makes sense; (vii) this is critical as long as Series A preferred holders represent, in aggregate, enough of your cap table to be relevant; (viii) you will never have to worry about this; (ix) this is fine, though you should try to get a higher limit or an exclusion for equipment financing in the normal course of business.

When future financing rounds occur (e.g., Series B, a new class of preferred stock), there is always a discussion as to how the protective provisions will work with regard to the new class. There are two cases: the Series B gets its own protective provisions or the Series B investors vote alongside the original investors as a single class. Entrepreneurs almost always will want a single vote for all the investors, as the separate investor class protective provision vote means the company now has two classes of potential veto constituents to deal with. Normally, new investors will ask for a separate vote, as their interests may diverge from those of the original investors due to different pricing, different risk profiles, and a false need for overall control. However, many experienced investors will align with the entrepreneur's point of view of not wanting separate class votes, as they do not want the potential headaches of another equity class vetoing an important company action. If Series B investors are the same as Series A investors, this is an irrelevant discussion and it should be easy for everyone to default to voting as a single class. If you have new investors in the Series B, be wary of inappropriate veto rights for small investors; for example, the consent percentage required is 90 percent instead of a majority (50.1 percent), enabling a new investor who owns only 10.1 percent of the financing to effectively assert control over the protective provisions through his vote.

The Entrepreneur's Perspective

Regardless of who your investors are, fight to have them vote as a single class. It's critical for your sanity. It keeps investors aligned. And as long as your capitalization table is rational, it won't matter.

Some investors feel they have enough control with their board involvement to ensure that the company does not take any action contrary to their interests, and as a result will not focus on these protective provisions. During a financing this is the typical argument used by company counsel to try to convince the VCs to back off of some or all of the protective provisions. We think this is a shortsighted approach for the investor, since, as a board member, an investor designee has legal duties to work in the best interests of the company. Sometimes the interests of the company and a particular class of shareholders diverge. Therefore, there can be times when an individual would legally have to approve something as a board member in the best interests of the company as a whole and not have a protective provision to fall back on as a shareholder. While this dynamic does not necessarily benefit the entrepreneur, it's good governance as it functionally separates the duties of a board member from those of a shareholder, shining a brighter light on an area of potential conflict.

While one could make the argument that protective provisions are at the core of the trust between a VC and an entrepreneur, we think that's a hollow and naive statement. When an entrepreneur asks, "Don't you trust me? Why do we need these things?" the simple answer is that it is not an issue of trust. Rather, we like to eliminate the discussion about who ultimately gets to make which decisions before we do a deal. Eliminating the ambiguity in roles, control, and rules of engagement is an important part of any financing, and the protective provisions cut to the heart of this.

Occasionally the protective provisions can help the entrepreneur, especially in an acquisition scenario. Since the investor can effectively block a sale of the company, this provides the entrepreneur with some addition leverage when negotiating with the buyer since the price needs to be high enough to garner the VC's consent on the deal. Of course, this assumes a reasonable position from the existing investor, but in most cases an experienced VC will support the entrepreneur's decision to sell a company.

A decade ago the protective provisions took several days to negotiate. Over time these provisions have been hotly tested in courts of law from several important judicial decisions, so today they have become mostly boilerplate.

The Entrepreneur's Perspective

Remember, you are negotiating this deal on behalf of the company (no matter who runs it in the future) and with the investors (no matter who owns the shares in the future). These terms are not only about your current relationship with the VC in question.

Drag-Along Agreement

Another important control provision is the *drag-along agreement*. Typical language follows:

> Drag-Along Agreement: The [holders of the Common Stock] or [Founders] and Series A Preferred shall enter into a drag-along agreement whereby if a majority of the holders of Series A Preferred agree to a sale or liquidation of the Company, the holders of the remaining Series A Preferred and Common Stock shall consent to and raise no objections to such sale.

The drag-along agreement gives a subset of the investors the ability to force, or drag along, all of the other investors and the founders to do a sale of the company, regardless of how the folks being dragged along feel about the deal.

After the Internet bubble burst and sales of companies started occurring that were at or below the liquidation preferences, entrepreneurs and founders—not surprisingly—started to resist selling the company in these situations since they often weren't getting anything in the deal. While there are several mechanisms to address sharing consideration below the liquidation preferences, such as the notion of a *carve-out*, which we'll discuss later, the fundamental issue is that if a transaction occurs below the liquidation preferences, it's likely that some or all of the VCs are losing money on the transaction. The VC point of view on this varies widely and is often dependent on the situation; some VCs can deal with this and are happy to provide some consideration to management to get a deal done, whereas others are stubborn in their view that since they lost money, management and founders shouldn't receive anything.

In each of these situations, the VCs would much rather control their ability to compel other shareholders to support the transaction. As more of these situations appeared, the major holders of common stock (even when they were in the minority of ownership) began refusing to vote for the proposed transaction unless the holders of preferred stock waived part of their liquidation preferences in favor of the common stock. Needless to say, this particular holdout technique did not go over well in the venture community and, as a result, the drag-along agreement became more prevalent.

If you are faced with a drag-along situation, your ownership position will determine whether or not this is an important issue for you. An acquisition does not require unanimous consent of shareholders; these rules vary by jurisdiction, although the two most common situations are either majority of each class (California) or majority of all shares on an as-converted basis (Delaware). However, most acquirers will want 85 percent to 90 percent of shareholders to consent to a transaction. If you own 1 percent of a company and the VCs would like you to sign up to a drag-along agreement, it doesn't matter that much unless there are 30 of you who each own 1 percent. Make sure you know what you are fighting for in the negotiation, and don't put disproportionate energy against terms that don't matter.

When a company is faced with a drag-along agreement in a VC financing proposal, the most common compromise position is to try to get the drag-along rights to pertain to following the majority of the common stock, not the preferred. This way, if you own common stock, you are dragged along only when a majority of the common stockholders consents to the transaction. This is a graceful position for a very small investor to take (e.g., "I'll play ball if a majority of the common plays ball") and one that we've always been willing to take when we've owned common stock in a company (e.g., "I'm not going to stand in the way of something a majority of folks who have rights equal to me want to do"). Of course, preferred investors can always convert some of their holdings to common stock to generate a majority, but this also results in a benefit to the common stockholders as it lowers the overall liquidation preference.

The Entrepreneur's Perspective

This is one of those terms that matter most if things are falling apart, in which case you probably have bigger fish to fry. And it cuts both ways—if you have a lot of investors, for example, this term can force them all to agree to a deal, which might save you from a lot of agitation down the road. Of course, it is best to not be in a fire sale situation, or at least to have enough board members whom you control (at least effectively, if not contractually) so that you can prevent a bad deal from happening in the first place.

Conversion

While many VCs posture during term sheet negotiations by saying things like "That is nonnegotiable," terms rarely are. Occasionally, though, a term will actually be nonnegotiable, and conversion is one such term.

The Entrepreneur's Perspective

Amen. "This is nonnegotiable" is usually a phrase thrown out by junior members of VC firms when they don't know any better. In particular, watch out for the "This is how we always do deals" or "This is a standard deal term for us" negotiating tactic as being ultra-lame and a sign that the people you're negotiating with don't really know what they are doing.

In all the VC deals we've ever seen, the preferred shareholders have the right—at any time—to convert their stake into common stock. Following is the standard language:

> Conversion: The holders of the Series A Preferred shall have the right to convert the Series A Preferred, at any time, into shares of Common Stock. The initial conversion rate shall be 1:1, subject to adjustment as provided below.

This allows the buyers of preferred to convert to common should they determine on a liquidation that they would be better off getting paid on an as-converted common basis rather than accepting the liquidation preference and the participation amount. It can also be used in certain extreme circumstances whereby the preferred wants to control a vote of the common on a certain issue. Note, however, that once converted, there is no provision for reconverting back to preferred.

A more interesting term is the automatic conversion, especially since it has several components that are negotiable.

> Automatic Conversion: All of the Series A Preferred shall be automatically converted into Common Stock, at the then applicable conversion price, upon the closing of a firmly underwritten public offering of shares of Common Stock of the Company at

> a per share price not less than [three] times the Original Purchase Price (as adjusted for stock splits, dividends, and the like) per share and for a total offering of not less than [$15] million (before deduction of underwriters' commissions and expenses) (a "Qualified IPO"). All, or a portion of each share, of the Series A Preferred shall be automatically converted into Common Stock, at the then applicable conversion price in the event that the holders of at least a majority of the outstanding Series A Preferred consent to such conversion.

In an IPO of a venture-backed company, the investment bankers will almost always want to see everyone convert into common stock at the time of the IPO. It is rare for a venture-backed company to go public with multiple classes of stock, although occasionally you will see dual classes of shares in an IPO as Google had. The thresholds for the automatic conversion are critical to negotiate. As the entrepreneur you want them lower to ensure more flexibility, whereas your investors will want them higher to give them more control over the timing and terms of an IPO.

Regardless of the actual thresholds, it's important to never allow investors to negotiate different automatic conversion terms for different series of preferred stock. There are many horror stories of companies on the brink of going public with one class of preferred stockholders having a threshold above what the proposed offering would result in; as a result, these stockholders have an effective veto right on the offering.

For example, assume that you have an early stage investor with an automatic conversion threshold of $30 million and a later stage investor with an automatic conversion threshold of $60 million. Now, assume you are at the goal line for an IPO and it's turning out to be a $50 million offering based on the market and the demand for your company. Your early investor is ready to go, but your later stage investor suddenly says, "I'd like a little something else since I can block the deal and even though you've done all of this work to get to an IPO, I don't think I can support it unless. . . ." In these cases, much last-minute legal and financial wrangling ensues given the lack of alignment between your different classes of investors. To avoid this, we strongly recommend that you equalize the automatic conversion threshold among all series of stock at each financing.

The Entrepreneur's Perspective

Understand what the norms are for new IPOs before you dig your heels in on conversion terms. There's no reason to negotiate away other more critical terms over a $20 million threshold versus a $30 million threshold if the norm is $50 million. Besides, a board decision to pursue an IPO will put pressure on a VC to waive this provision.