CHAPTER 6

Other Terms of the Term Sheet

Up to this point we've been exploring terms that matter a lot and fall under the category of economics or control. As we get further into the term sheet, we start to encounter some terms that don't matter as much, are only impactful in a downside scenario, or don't matter at all.

This chapter covers those terms, which include dividends, redemption rights, conditions precedent to financing, information rights, registration rights, right of first refusal, voting rights, restriction on sales, proprietary information and inventions agreement, co-sale agreement, founders' activities, initial public offering shares purchase, no-shop agreement, indemnification, and assignment.

Dividends

Whereas private equity guys love dividends, many venture capitalists, especially early stage ones, don't really care about them. In our experience, the VCs who do care about dividends either come from a private equity background or are focused on downside protection in larger deals.

Typical dividend language in a term sheet follows:

> Dividends: The holders of the Series A Preferred shall be entitled to receive [non]cumulative dividends in preference to any dividend on the Common Stock at the rate of [8 percent] of the Original Purchase Price per annum[, when and as declared by the Board of Directors]. The holders of Series A Preferred also

shall be entitled to participate pro rata in any dividends paid on the Common Stock on an as-if-converted basis.

For early stage investments, dividends generally do not provide venture returns—they are simply additional juice in a deal. Let's do some simple math. Assume a typical dividend of 10 percent (dividends will range from 5 to 15 percent depending on how aggressive your investor is; we picked 10 percent to make the math easy).

Now, assume that the VC has negotiated hard and gotten a 10 percent cumulative annual dividend. In this case, the VC automatically gets the dividend every year. To keep the math simple, let's assume the dividend does not compound. As a result, each year the VC gets 10 percent of the investment as a dividend. Assume a home run deal such as a 50× return on a $10 million investment in five years. Even with a 10 percent cumulative annual dividend, this increases the VC's return from $500 million to only $505 million (the annual dividend is $1 million, or 10 percent of $10 million, times five years).

While the extra money from the dividend is nice, it doesn't really move the needle in the success case. Since venture funds typically have a 10-year life, the dividend generates another 1× return only if you invest on day one of a fund and hold the investment for 10 years.

This also assumes the company can actually pay out the dividend. Usually the dividends can be paid in either stock or cash, typically at the option of the company. Obviously, the dividend could drive additional dilution if it is paid out in stock, so this is the one case in which it is important not to get head-faked by the investor, where the dividend becomes another form of antidilution protection—one that is automatic and simply linked to the passage of time.

We are being optimistic about the return scenarios. In downside cases, the dividend can matter, especially as the invested capital increases. For example, take a $40 million investment with a 10 percent annual cumulative dividend in a company that was sold at the end of the fifth year to another company for $80 million. In this case, assume that there was a simple liquidation preference with no participation and the investor got 40 percent of the company for his investment (at a $100 million postmoney valuation). Since the sale price was below the investment postmoney valuation (i.e., a loser, but not a disaster), the investor will exercise the liquidation preference and take the $40 million plus the dividend ($4 million per year for five years, or $20 million). In this case, the difference between the return in a no-dividend scenario ($40 million) and a dividend scenario ($60 million) is material.

Mathematically, the larger the investment amount and the lower the expected exit multiple, the more the dividend matters. This is why you see dividends in private equity and buyout deals where big money is involved (typically greater than $50 million) and the expectation for return multiples on invested capital is lower.

Automatic dividends have some nasty side effects, especially if the company runs into trouble, since they typically should be included in the solvency analysis. If you aren't paying attention, an automatic cumulative dividend can put you unknowingly into the *zone of insolvency*, which is a bad place to be. Cumulative dividends can also be an accounting nightmare, especially when they are optionally paid in stock, cash, or a conversion adjustment, but that's why the accountants get paid the big bucks at the end of the year to put together the audited balance sheet.

That said, the noncumulative dividend when declared by the board is benign, rarely declared, and an artifact of the past, so we typically leave it in term sheets just to give the lawyers something to do.

The Entrepreneur's Perspective

The thing to care about here is ensuring that dividends have to be approved by a majority—or even a supermajority—of your board of directors.

Redemption Rights

Even though redemption rights rarely come into play, many VCs are often overly focused on them in the deal because they provide additional downside protection. A typical redemption rights clause follows:

> Redemption at Option of Investors: At the election of the holders of at least a majority of the Series A Preferred, the Company shall redeem the outstanding Series A Preferred in three annual installments beginning on the [fifth] anniversary of the

> Closing. Such redemptions shall be at a purchase price equal to the Original Purchase Price plus declared and unpaid dividends.

There is some rationale for redemption rights. First, there is the fear (on the VC's part) that a company will become successful enough to be an ongoing business but not quite successful enough to go public or be acquired. In this case, redemption rights were invented to allow the investor a guaranteed exit path. However, a company that is around for a while as a going concern while not being an attractive initial public offering (IPO) or acquisition candidate generally won't have the cash to pay out redemption rights.

Another reason for redemption rights pertains to the life span of venture funds. The average venture fund has a 10-year life span to conduct its business. If a VC makes an investment in year five of the fund, it might be important for that fund manager to secure redemption rights in order to have a liquidity path before the fund must wind down. As with the previous case, whether or not the company has the ability to pay is another matter.

Often, companies will claim that redemption rights create a liability on their balance sheet and can make certain business optics more difficult. By optics, we mean how certain third-parties view the health and stability of the company such as bankers, customers and employees. In the past few years, accountants have begun to argue more strongly that redeemable preferred stock is a liability on the balance sheet, not an equity feature. Unless the redeemable preferred stock is mandatorily redeemable, this is not the case, and most experienced accountants will be able to recognize the difference.

There is one form of redemption that we have seen in the past few years that we view as overreaching—the *adverse change redemption*. We recommend you never agree to the following term that has recently crept into term sheets:

> Adverse Change Redemption: Should the Company experience a material adverse change to its prospects, business, or financial position, the holders of at least a majority of the Series A Preferred shall have the option to commit the Company to immediately redeem the outstanding Series A Preferred. Such redemption shall be at a purchase price equal to the Original Purchase Price plus declared and unpaid dividends.

This term effectively gives the VC a right to a redemption in the case of a “material adverse change to its . . . business.” The problem is that “material adverse change” is not defined, is a vague concept, is too punitive, and shifts an inappropriate amount of control to the investors based on an arbitrary judgment of the investors. If this term is being proposed and you are getting resistance on eliminating it, make sure you are speaking to a professional investor and not a loan shark.

In our experience, redemption rights are well understood by VCs and should not create a problem, except in a theoretical argument between lawyers and accountants.

The Entrepreneur’s Perspective

I don’t worry about redemption rights much, although the adverse change redemption clause is evil. As with dividends, just make sure you have maximum protection around your board, or all classes of preferred shareholders voting in aggregate, and not just the majority of a random class of shareholder declaring these.

Conditions Precedent to Financing

While there is a lot to negotiate, a term sheet is simply a step on the way to an actual deal. Term sheets are often nonbinding (or mostly nonbinding) and most VCs will load them up with conditions precedent to financing. Entrepreneurs glance over these, usually because they are in the back sections of the term sheet and seem pretty innocuous, but they occasionally have additional ways out of a deal for the investor that the entrepreneur should watch for, if only to better understand the current mind-set of the investor proposing the investment.

A typical conditions precedent to financing clause looks like this:

> Conditions Precedent to Financing: Except for the provisions contained herein entitled “Legal Fees and Expenses,” “No-Shop Agreement,” and “Governing Law,” which are explicitly agreed by the Investors and the Company to be binding upon execution of this term sheet, this summary of terms is not intended as a legally binding commitment by the Investors, and any obligation

> on the part of the Investors is subject to the following conditions precedent: 1. Completion of legal documentation satisfactory to the prospective Investors; 2. Satisfactory completion of due diligence by the prospective Investors; 3. Delivery of a customary management rights letter to Investors; and 4. Submission of a detailed budget for the following twelve (12) months, acceptable to Investors.

Note that the investors will try to make a few things binding—specifically that legal fees get paid whether or not a deal happens, the company can't shop the deal once the term sheet is signed, or the governing law be set to a specific domicile—while explicitly stating that a bunch things still have to happen before this deal is done, and they can back out for any reason.

The Entrepreneur's Perspective

Try to avoid conditions precedent to financing as much as possible. Again, the best Plan A has the strongest Plan B standing behind it. Your prospective VC should be willing to move quickly and snap up your deal on acceptable terms by the time the VC gets to a term sheet. At a minimum, do not agree to pay for the VC's legal fees unless the deal is completed (with a possible carve-out for you canceling the deal).

There are three conditions to watch out for since they usually signal something nonobvious on the part of the VC. They are:

1. *Approval by investors' partnerships.* This is secret VC code for "This deal has not been approved by the investors who issued this term sheet." Therefore, even if you love the terms of the deal, you still may not have a deal.
2. *Rights offering to be completed by company.* This indicates that the VCs want to offer all previous investors in the company the ability to participate in the currently contemplated financing. This is not necessarily a bad thing, as in most cases it serves to protect all parties from liability, but it does add time and expense to the deal.

3. *Employment agreements signed by founders as acceptable to investors.* Be aware of what the full terms are before signing the agreement. As an entrepreneur, when faced with this, it's probably wise to understand and negotiate the form of employment agreement early in the process. You'll want to try to do this before you sign a term sheet and accept a no-shop clause, but most VCs will wave you off and say, "Don't worry about it—we'll come up with something that works for everyone." Make sure you understand the key terms such as compensation and what happens if you get fired.

The Entrepreneur's Perspective

Insist on spelling out key terms prior to a signed term sheet if it has a no-shop clause in it. A VC who won't spell out key employment terms at the beginning is a big red flag.

There are plenty of other wacky conditions—if you can dream it up, it has probably been done. Just make sure to look carefully at this paragraph and remember that you don't necessarily have a deal just because you've signed a term sheet.

Information Rights

We are back to another ubiquitous term that is important to the VC but shouldn't matter much to the entrepreneur. Information rights define the type of information the VC legally has access to and the time frame in which the company is required to deliver it to the VC.

> Information Rights: So long as an Investor continues to hold [any] shares of Series A Preferred or Common Stock issued upon conversion of the Series A Preferred, the Company shall deliver to the Investor the Company's annual budget, as well as audited annual and unaudited quarterly financial statements. Furthermore, as soon as reasonably possible, the Company shall furnish a report to each Investor comparing each annual budget to such financial statements. Each Investor shall also be entitled to standard inspection and visitation rights. These provisions shall terminate upon a Qualified IPO.

You might ask, "If these terms rarely matter, why bother?" Since you will end up having to deal with them in a VC term sheet, you might as well be exposed to them and hear that they don't matter much. Of course, from a VC perspective, "doesn't matter much" can also mean "Mr. Entrepreneur, please don't pay much attention to these terms—just accept them as is." However, our view is that if an investor or the company is hotly negotiating this particular term, that time (and lawyer money) is most likely being wasted.

Information rights are generally something companies are stuck with in order to get investment capital. The only variation one sees is putting a threshold on the number of shares held (some finite number versus "any") for investors to continue to enjoy these rights.

The Entrepreneur's Perspective

If you care about information rights for your shareholders, you are nuts. You should run a transparent organization as much as possible in the twenty-first century. If you can't commit to sending your shareholders a budget and financial statements, you shouldn't take on outside investors. If you are of the paranoid mind-set (which I generally applaud), feel free to insist on a strict confidentiality clause to accompany your information rights.

Registration Rights

Registration rights define the rights that investors have to registering their shares in an IPO scenario as well as the obligation of the company to the VCs whenever they file additional registration statements after the IPO. This is a tedious example of something that rarely matters, yet tends to take up a page or more of the term sheet. Get ready for your mind to be numbed.

> Registration Rights: Demand Rights: If Investors holding more than 50 percent of the outstanding shares of Series A Preferred, including Common Stock issued on conversion of Series A Preferred ("Registrable Securities"), or a lesser percentage if the anticipated aggregate offering price to the public is not less than $5,000,000, request that the Company file a Registration Statement, the Company will use its best efforts to cause such shares to be registered; provided, however, that the Company shall not

be obligated to effect any such registration prior to the [third] anniversary of the Closing. The Company shall have the right to delay such registration under certain circumstances for one period not in excess of ninety (90) days in any twelve (12)-month period.

The Company shall not be obligated to effect more than two (2) registrations under these demand right provisions, and shall not be obligated to effect a registration (i) during the one hundred eighty (180)-day period commencing with the date of the Company's initial public offering, or (ii) if it delivers notice to the holders of the Registrable Securities within thirty (30) days of any registration request of its intent to file a registration statement for such initial public offering within ninety (90) days.

Company Registration: The Investors shall be entitled to "piggyback" registration rights on all registrations of the Company or on any demand registrations of any other investor subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions. If the Investors are so limited, however, no party shall sell shares in such registration other than the Company or the Investor, if any, invoking the demand registration. Unless the registration is with respect to the Company's initial public offering, in no event shall the shares to be sold by the Investors be reduced below 30 percent of the total amount of securities included in the registration. No shareholder of the Company shall be granted piggyback registration rights which would reduce the number of shares includable by the holders of the Registrable Securities in such registration without the consent of the holders of at least a majority of the Registrable Securities.

S-3 Rights: Investors shall be entitled to unlimited demand registrations on Form S-3 (if available to the Company) so long as such registered offerings are not less than $1,000,000.

Expenses: The Company shall bear registration expenses (exclusive of underwriting discounts and commissions) of all such demands, piggybacks, and S-3 registrations (including the expense of one special counsel of the selling shareholders not to exceed $25,000).

Transfer of Rights: The registration rights may be transferred to (i) any partner, member, or retired partner or member or affiliated fund of any holder which is a partnership, (ii) any member or former member of any holder which is a limited liability company, (iii) any family member or trust for the benefit of any individual holder, or (iv) any transferee who satisfies the criteria to be a Major Investor (as defined below); provided the Company is given written notice thereof.

Lockup Provision: Each Investor agrees that it will not sell its shares for a period to be specified by the managing underwriter (but not to exceed 180 days) following the effective date of the Company's initial public offering; provided that all officers, directors, and other 1 percent shareholders are similarly bound. Such lockup agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of underwriters shall apply to Major Investors, pro rata, based on the number of shares held.

Other Provisions: Other provisions shall be contained in the Investor Rights Agreement with respect to registration rights as are reasonable, including cross-indemnification, the period of time in which the Registration Statement shall be kept effective, and underwriting arrangements. The Company shall not require the opinion of Investor's counsel before authorizing the transfer of stock or the removal of Rule 144 legends for routine sales under Rule 144 or for distribution to partners or members of Investors.

Registration rights are something the company will almost always have to offer to investors. What is most interesting about registration rights is that lawyers seem genetically incapable of leaving this section untouched and always end up negotiating something. Perhaps because this provision is so long, they feel the need to keep their pens warm while reading. We find it humorous (as long as we aren't the ones paying the legal fees), because in the end, the modifications are generally innocuous, and besides, if you ever get to the point where registration rights come into play (e.g., an IPO), the investment bankers of the company are going to have a major hand in deciding how the deal is going to be structured, regardless of the contract the company entered into years before when it did an early stage financing.

The Entrepreneur's Perspective

Don't focus much energy on registration rights. This is more about upside. The world is good if you're going public.

Right of First Refusal

The right of first refusal defines the rights that an investor has to buy shares in a future financing. Right of first refusal is another chewy term that takes up a lot of space in the term sheet but is hard for the entrepreneur to have much impact on. Following is the typical language.

> Right of First Refusal: Investors who purchase at least __ shares of Series A Preferred (a "Major Investor") shall have the right in the event the Company proposes to offer equity securities to any person, other than the shares (i) reserved as employee shares described under "Employee Pool" below; (ii) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board; (iii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement, or debt financing from a bank or similar financial institution approved by the Board; and (iv) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their right of first refusal, to purchase [X] times their pro rata portion of such shares. Any securities not subscribed for by an eligible Investor may be reallocated among the other eligible Investors. Such right of first refusal will terminate upon a Qualified IPO. For purposes of this right of first refusal, an Investor's pro rata right shall be equal to the ratio of (a) the number of shares of common stock (including all shares of common stock issuable or issued upon the conversion of convertible securities and assuming the exercise of all outstanding warrants and options) held by such Investor immediately prior to the issuance of such

> equity securities to (b) the total number of share of common stock outstanding (including all shares of common stock issuable or issued upon the conversion of convertible securities and assuming the exercise of all outstanding warrants and options) immediately prior to the issuance of such equity securities.

The right of first refusal is also known as a *pro rata right*. While almost all VCs will insist on a right of first refusal, there are two things to pay attention to in this term that can be negotiated. First, the share threshold that defines a *major investor* can be defined. It's often convenient, especially if you have a large number of small investors, not to have to give this right to them. However, since in future rounds you are typically interested in getting as much participation from your existing investors as you can, it's not worth struggling with this too much.

A more important thing to look for is to see if there is a multiple on the purchase rights (e.g., the "[X] times" listed). This is often referred to as a *super pro rata right* and is an excessive ask, especially early in the financing life cycle of a company.

The Entrepreneur's Perspective

The right of first refusal is not a big deal, and in some cases it's good for you. But make sure you define what a major investor is and give this only to them. At a minimum, you can make sure that shareholders get this right only if they play in subsequent rounds.

Voting Rights

Voting rights define how the preferred stock and the common stock relate to each other in the context of a share vote. It is another term that doesn't matter that much. The typical language follows:

> Voting Rights: The Series A Preferred will vote together with the Common Stock and not as a separate class except as specifically provided herein or as otherwise required by law. The Common Stock may be increased or decreased by the vote of holders of a majority of the Common Stock and Series A Preferred voting together on an as-if-converted basis, and without a separate class

> vote. Each share of Series A Preferred shall have a number of votes equal to the number of shares of Common Stock then issuable upon conversion of such share of Series A Preferred.

Most of the time the voting rights clause is simply an FYI section, as all the important rights, such as the protective provisions, are contained in other sections.

Restriction on Sales

The restriction on sales clause, also known as the right of first refusal on sales of common stock (or ROFR on common) defines the parameters associated with selling shares of stock when the company is a private company. Typical language follows:

> Restrictions on Sales: The Company's Bylaws shall contain a right of first refusal on all transfers of Common Stock, subject to normal exceptions. If the Company elects not to exercise its right, the Company shall assign its right to the Investors.

Historically, founders and management rarely argue against this, as it helps control the shareholder base of the company, which usually benefits all the existing shareholders (except possibly the ones who want to bail out of their private stock). However, we've found that the lawyers will often spend time arguing about how to implement this particular clause—specifically whether to include it in the bylaws or include it in each of the company's option agreements, plans, and stock sales. We find it easier to include this clause in the bylaws since then it's in one place and is hard to overlook.

In the early days of venture capital (say, until 2007) there was a strong conventional wisdom that founders and management shouldn't be able to sell their shares until the investors could sell their shares, through either an IPO or a sale of the company. As the time to liquidity for private companies stretched out and IPOs became less common, this philosophy shifted. Simultaneously, a healthy secondary market for founders and early employee shares appeared, fueled both by the rapid rise in valuation of private companies such as Facebook and Twitter, along with the emergence of private secondary markets such as Second Market and SharesPost. The result is a lot more sales of private stock to other investors (sometimes new ones, sometimes the existing investors) along with much more scrutiny and discussion around the ROFR on common construct.

After being involved in several situations where this has come into play, we feel more strongly than ever that an ROFR on common is a good thing for the company and should be supported by the founders, management, and investors. Controlling the share ownership in a private company is important, especially as the Securities and Exchange Commission (SEC) takes a closer look at various private shareholder rules—both regarding ownership and for stock sales. The ROFR on common gives the company the ability to at least know what is going on and make decisions in the context of the various proposals.

Proprietary Information and Inventions Agreement

Every term sheet we've ever seen has a proprietary information and inventions agreement clause.

> Proprietary Information and Inventions Agreement: Each current and former officer, employee, and consultant of the Company shall enter into an acceptable proprietary information and inventions agreement.

This paragraph benefits both the company and investors and is simply a mechanism that investors use to get the company to legally stand behind the representation that it owns its intellectual property (IP). Many pre–Series A companies have issues surrounding this, especially if the company hasn't had great legal representation prior to its first venture round. We've also run into plenty of situations (including several of ours—oops!) in which companies are loose about this between financings and, while a financing is a good time to clean this up, it's often annoying to previously hired employees who are now told, "Hey—you need to sign this since we need it for the venture financing." It's even more important in the sale of a company, as the buyer will always insist on clear ownership of the IP. Our best advice here is that companies should build these agreements into their hiring process from the very beginning (with the advice from a good law firm) so that there are never any issues around this, as VCs will always insist on this agreement.

The Entrepreneur's Perspective

A proprietary information and inventions agreement clause is good for the company. You should have all employees, including founders, sign something like this before you do an outside venture financing. If someone on the team needs a specific carve-out for work in progress that is unrelated to the business, you and your investors should be willing to grant it.

Co-Sale Agreement

Most investors will insist on a co-sale agreement, which states that if a founder sells shares, the investors will have an opportunity to sell a proportional amount of their stock as well. Typical language follows:

> Co-Sale Agreement: The shares of the Company's securities held by the Founders shall be made subject to a co-sale agreement (with certain reasonable exceptions) with the Investors such that the Founders may not sell, transfer, or exchange their stock unless each Investor has an opportunity to participate in the sale on a pro rata basis. This right of co-sale shall not apply to and shall terminate upon a Qualified IPO.

The chance of keeping this provision out of a financing is close to zero, so we don't think it's worth fighting it. Notice that this matters only while the company is private—if the company goes public, this clause no longer applies.

The Entrepreneur's Perspective

Your chances of eliminating the co-sale agreement clause may be zero, but there's no reason not to ask for a floor to it. If you or your co-founders want to sell a small amount of stock to buy a house, why should a VC hold it up? A right of first refusal on the purchase with a bona fide outside offer's valuation as the purchase price is one thing. An effective exclusion is something entirely different.

Founders' Activities

As you wind your way through a typical term sheet, you'll often see, buried near the back, a short clause concerning founders' activities. It usually looks something like this:

> Founders' Activities: Each of the Founders shall devote 100 percent of his professional time to the Company. Any other professional activities will require the approval of the Board of Directors.

It should be no surprise to a founder that your friendly neighborhood VC wants you to be spending 100 percent (actually 120 percent) of your time and attention on your company. If this paragraph sneaks its way into the term sheet, the VC either has recently been burned, is suspicious, or is concerned that one or more of the founders may be working on something besides the company being funded.

Of course, this is a classic no-win situation for a founder. If you are actually working on something else at the same time and don't disclose it, you are violating the terms of the agreement in addition to breaching trust before you get started. If you do disclose other activities or push back on this clause (hence signaling that you are working on something else), you'll reinforce the concern that the VC has. So tread carefully here. Our recommendation, unless of course you are working on something else, is simply to agree to this.

In situations where we've worked with a founder who already has other obligations or commitments, we've always appreciated him being up front with us early in the process. We've usually been able to work through these situations in a way that results in everyone being happy and, in the cases where we couldn't get there, were glad that the issue came up early so that we didn't waste our time or the entrepreneur's time.

While there are situations where VCs get comfortable with entrepreneurs working on multiple companies simultaneously (usually with very experienced entrepreneurs or in situations where the VC and the entrepreneur have worked together in the past), they are the exception, not the norm.

The Entrepreneur's Perspective

If you can't agree to a founders' activities clause, don't look for professional VC financing. Or you can negotiate a very specific carve-out, and expect other consequences in your terms (e.g., vesting and IP rights).

Initial Public Offering Shares Purchase

One of the terms that falls into the "nice problem to have" category is the initial public offering shares purchase.

> Initial Public Offering Shares Purchase: In the event that the Company shall consummate a Qualified IPO, the Company shall use its best efforts to cause the managing underwriter or underwriters of such IPO to offer to [investors] the right to purchase at least [5 percent] of any shares issued under a "friends and family" or "directed shares" program in connection with such Qualified IPO. Notwithstanding the foregoing, all action taken pursuant to this Section shall be made in accordance with all federal and state securities laws, including, without limitation, Rule 134 of the Securities Act of 1933, as amended, and all applicable rules and regulations promulgated by the National Association of Securities Dealers, Inc. and other such self-regulating organizations.

This term blossomed in the late 1990s when anything that was VC funded was positioned as a company that would shortly go public. However, most investment bankers will push back on this term if the IPO is going to be a success, as they want to get stock into the hands of institutional investors (their clients). If the VCs get this push-back, they are usually so giddy with joy that the company is going public that they don't argue with the bankers. Ironically, if they don't get this push-back, or even worse, get a call near the end of the IPO road show in which the bankers are asking them to buy shares in the offering, they usually panic and do whatever they can to not have to buy into the offering since this means the deal is no longer a hot one.

Our recommendation on this one is don't worry about it or spend lawyer time on it.

No-Shop Agreement

As an entrepreneur, the way to get the best deal for a round of financing is to have multiple options. However, there comes a point in time when you have to choose your investor and shift from "search for an investor" mode to "close the deal" mode. Part of this involves choosing your lead investor and negotiating the final term sheet with him.

A no-shop agreement is almost always part of this final term sheet. Think of it as serial monogamy—your new investor-to-be doesn't want you running around behind his back just as you are about to get hitched. A typical no-shop agreement follows:

> No-Shop Agreement: The Company agrees to work in good faith expeditiously toward a closing. The Company and the Founders agree that they will not, directly or indirectly, (i) take any action to solicit, initiate, encourage, or assist the submission of any proposal, negotiation, or offer from any person or entity other than the Investors relating to the sale or issuance of any of the capital stock of the Company or the acquisition, sale, lease, license, or other disposition of the Company or any material part of the stock or assets of the Company, or (ii) enter into any discussions or negotiations or execute any agreement related to any of the foregoing, and shall notify the Investors promptly of any inquiries by any third parties in regard to the foregoing. Should both parties agree that definitive documents shall not be executed pursuant to this term sheet, then the Company shall have no further obligations under this section.

At some level the no-shop agreement, like serial monogamy, is more of an emotional commitment than a legal one. While it's very hard, but not impossible, to enforce a no-shop agreement in a financing, if you get caught cheating, your financing will probably go the same way as the analogous situation when the groom or the bride-to-be gets caught in a compromising situation.

The no-shop agreement reinforces the handshake that says, "Okay, let's get a deal done—no more fooling around looking for a better or different one." In all cases, the entrepreneur should bound the no-shop agreement by a time period—usually 45 to 60 days is plenty, although you can occasionally get a VC to agree to a 30-day no-shop agreement. This makes the commitment bidirectional—you agree not to shop the deal; the VC agrees to get things done within a reasonable time frame.

Now, some entrepreneurs still view that as a unilateral agreement; namely, the entrepreneur is agreeing to the no-shop but the VC isn't really agreeing to anything at all. In most cases, we don't view the no-shop clause as terribly important since it can be bounded with time. Instead, we feel it's much more important for the entrepreneur to test the VCs commitment to follow through on the investment when signing up to do the deal.

Specifically, in some cases VCs put down term sheets early, well before they've got internal agreement within their partnership to do an investment. This used to be more common; today many early stage VCs don't want to go through the hassle of drafting the term sheet and trying to negotiate it unless they believe they will do the deal. In addition, there is a potential negative reputational impact for the VC, as word will get around that VC X puts term sheets out early, but then can't or won't close. In the age of the Internet, this type of reputation spreads like an infectious disease.

Although we've done hundreds of investments, we came up with only a few examples in the past 15 years where the no-shop agreement had any meaningful impact on a deal in which we were involved. When we thought about the situations in which we were the VC and were negatively impacted by not having a no-shop agreement (e.g., a company we had agreed with on a term sheet went and did something else) or where we were on the receiving end of a no-shop agreement and were negatively impacted by it (e.g., an acquirer tied us up but then ultimately didn't close on the deal), we actually didn't feel particularly bad about any of the situations since there were both logic associated with the outcome and grace exhibited by the participants. Following are two examples:

We signed a term sheet to invest in Company X. We didn't include a no-shop clause in the term sheet. We were working to close the investment (we were 15 days into a 30-ish-day process) and had legal documents going back and forth. One of the founders called us and said that they had just received an offer to be acquired and they wanted to pursue it. We told them no problem—we'd still be there to do the deal if it didn't come together. We were very open with them about the pros and cons of doing the deal from our perspective and, given the economics, encouraged them to pursue the acquisition offer (it was a great deal for them). They ended up closing the deal and, as a token, gave us a small amount of equity in the company for our efforts (totally unexpected and unnecessary, but appreciated).

In another situation we were already investors in a company that was in the process of closing an outside-led round at a significant step-up in valuation. The company was under a no-shop agreement with the new VC. A week prior to closing, we received an acquisition overture from one of the strategic investors in the company. We immediately told the new lead investor about it, who graciously agreed to suspend the no-shop agreement and wait to see whether we wanted to move forward with the acquisition or with the financing. We negotiated with the acquirer for several weeks, checking regularly with the new potential investor to make sure they were still interested in closing the round if we chose not to pursue the acquisition. They were incredibly supportive and patient. The company covered its legal fees up to that point (unprompted—although it was probably in the term sheet that we'd cover them; we can't recall). We ended up moving forward with the acquisition; the new investor was disappointed in the outcome but happy and supportive of what we did.

While both of these are edge cases, in almost all of our experiences the no-shop agreement ended up being irrelevant. As each of these examples shows, the quality and the character of the people involved made all the difference and were much more important than the legal term.

The Entrepreneur's Perspective

As an entrepreneur, you should also ask that the no-shop clause expire immediately if the VC terminates the process. Also, consider asking for a carveout for acquisitions. Frequently financings and acquisitions follow each other around. Even if you're not looking to be acquired, you don't want handcuffs on conversations about an acquisition just because a VC is negotiating with you about a financing.

Indemnification

The indemnification clause states that the company will indemnify investors and board members to the maximum extent possible by law. It is another one that entrepreneurs just have to live with. It follows:

> Indemnification: The bylaws and/or other charter documents of the Company shall limit board members' liability and exposure to damages to the broadest extent permitted by applicable law. The Company will indemnify board members and will indemnify each Investor for any claims brought against the Investors by any third party (including any other shareholder of the Company) as a result of this financing.

Given all the shareholder litigation in recent years, there is almost no chance that a company will get funded without indemnifying its directors. The first sentence is simply a contractual obligation between the company and its board. The second sentence, which is occasionally negotiable, indicates the desire for the company to purchase formal liability insurance. One can usually negotiate away insurance in a Series A deal, but for any follow-on financing the major practice today is to procure directors' and officers' (D&O) insurance. We believe companies should be willing to indemnify their directors and will likely need to purchase D&O insurance in order to attract outside board members.

The Entrepreneur's Perspective

You should have reasonable and customary directors' and officers' (D&O) insurance for yourself as much as for your VCs. While the indemnification clause is good corporate hygiene, make sure you follow it up with an appropriate insurance policy.

Assignment

We end this chapter with the assignment clause, another clause in a typical term sheet that isn't worth spending legal time and money negotiating.

> Assignment: Each of the Investors shall be entitled to transfer all or part of its shares of Series A Preferred purchased by it to one or more affiliated partnerships or funds managed by it or any of their respective directors, officers, or partners, provided such transferee agrees in writing to be subject to the terms of the Stock Purchase Agreement and related agreements as if it were a purchaser thereunder.

The assignment clause simply gives VC firms flexibility over transfers that they require to be able to run their business and, as long as the VC is willing to require that any transferee agree to be subject to the various financing agreements, the company should be willing to provide for this. However, watch out for one thing—don't let the loophole "assignment without transfer of the obligation under the agreements" occur. You need to make sure that anyone who is on the receiving end of a transfer abides by the same rules and conditions that the original purchasers of the stock signed up for.