Preferred Stock Term Sheets: Five Negotiation Points That Matter

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September 30, 2026



In preferred stock financing term sheets, there are a number of important terms that investors and companies will negotiate regarding various rights for investors or concerning control and governance of the company. It is important for both companies and investors to become familiar with such terms to understand the impact they may have on the future of a company or an investment. This article is a primer on five material points that should be considered when negotiating a preferred stock term sheet.

1. Pre-Money Valuation and Other Important Economics

Pre-Money Valuation

The valuation of a company is typically expressed in pre-money and post-money terms. Pre-money valuation means the value of the company prior to the investment round. Post-money valuation refers to the value of the company following the investment. For example, if the company has a pre-money valuation of $10,000,000 and the investment round raises $3,000,000, then the post-money valuation will be $13,000,000.

Pre-money valuations are typically based upon various factors including customer/user traction, revenues, reputation of founders, perceived market opportunity, competition, barriers to entry, intellectual property, and trends in the particular industry. Pre-money valuations are usually heavily negotiated between investors and companies.

The pre-money valuation of a company is important because the higher the valuation, the lower the percentage of ownership of the company that would be allocated to investors in exchange for their investment, which would result in a less dilutive impact on founders. Companies will therefore typically want to see this number higher to give up less ownership, while investors will want this number lower so that they obtain more ownership of the company for their investment.

Each investment round will have a dilutive impact on the founders. In addition, a stock option reserve for stock option grants to help retain employees and hire skilled talent is usually included in the pre-money capitalization, and this number additionally dilutes existing stockholders. The smaller the pool, the less dilution. Most investors will want to see the stock option reserve in the pre-money capitalization so that they are not immediately diluted upon investing.

Founder Vesting

Investors may ask founders to add certain vesting terms to their stock pursuant to which, if the founder leaves during the vesting period, the company will have a right to repurchase the

unvested shares. The shares subject to vesting are often referred to as restricted stock, and a founder typically should consider making an 83(b) election with respect to such stock, subject to applicable tax considerations and the applicable filing deadline. Some founders may try to negotiate vesting terms to be minimal, to receive vesting credit for the time they dedicated to the company to date, or to not be subject to vesting at all, while some investors may require vesting terms to ensure the founders are incentivized to remain committed to the company.

Liquidation Preference

Preferred stock will typically have a liquidation preference over the common stock, which serves as downside protection for investors in the event of a liquidation event. Preferred stockholders with a liquidation preference would have a priority on the return of their investment upon an exit prior to common stockholders getting paid. Sometimes, with more complex capitalization tables and multiple series of preferred stock, there can be different terms negotiated, such as the Series A getting paid before the Series Seed, which is paid before the common.

Dividends

Dividends can be negotiated to be cumulative or non-cumulative and are typically paid out to stockholders based upon a company's profits and if approved by the board of directors. Non-cumulative dividends will not accumulate, and, therefore, if there are no dividend payments that are declared to be paid by a board of directors, no dividends will accrue for such time period. Cumulative dividends on the other hand will accrue and can be paid out when declared by the board of directors or upon a future event, such as the sale of the company.

Anti-dilution Protection

Anti-dilution provisions are another term that can be negotiated in the term sheet. These provisions would protect investors in the scenario of a down-round (meaning a future financing round that has a valuation in which the price per share would be less than the current round of investment), pursuant to which the price at which the preferred stock converts to common would be adjusted to reflect the new weighted-average price for such shares. An atypical form of anti-dilution protection that is more punitive to the company's common stockholders would be full-ratchet anti-dilution, which would result in a larger conversion rate adjustment than a weighted average by reducing the conversion price of the existing preferred to the price at which new shares are issued in a later round.

2. Control and Governance

Board of Directors and Observers

The composition of the board of directors is a key way to maintain control and governance over a company. Frequently, a lead investor who is investing a high dollar amount in a preferred stock financing will request to have the right to designate a preferred stock director to the board of directors. Other times, an investor will negotiate to have a non-voting board observer attend the board meetings.

Protective Provisions

Another topic in term sheets that is usually heavily negotiated is the preferred stockholder protective provisions. These provisions will require that before a company takes certain key actions, a designated percent of preferred stockholders must approve doing so. For example, a typical provision might state that without the majority of the preferred stockholders voting together as a single class on an as-converted basis, the company cannot amend and restate its certificate of incorporation or bylaws, pay dividends, or liquidate. A comprehensive list of protective provisions may be negotiated into the term sheet, and the percent of stockholder vote could sometimes be higher than a majority if a group of stockholders are trying to get a block (meaning their vote would be necessary). For this section, it is important for companies to remember that they must solicit stockholder approval for these items, and depending on the size

and composition of the company's stockholder base, it might not always be easy, so companies will typically try to limit the list of protective provisions. On the other hand, this section is important to investors because it allows them to have a vote on certain key company actions prior to their occurrence.

Preferred Director Approvals

Another form of control and governance that can be negotiated into the term sheet is matters that require preferred director approval. This section would typically state that, so long as there is at least one preferred director, the company cannot, without the approval of the board of directors, which approval must include at least one preferred director, take action on a number of material items (e.g., make a loan or advance to any other person, incur any indebtedness over a certain amount, or hire, terminate or change the compensation of any executive officers). Sometimes, for later stage companies with multiple preferred directors, this provision would require the vote of a majority of the preferred directors or such other composition that is negotiated in the term sheet stage. This section would give control and a potential blocking vote on certain actions to the preferred director(s), so each item should be carefully negotiated.

3. Investment Monitoring and Information Rights

Financial Reporting; Inspection Rights

There are a number of ways for an investor to monitor its investment, such as through board of director or observer roles, receiving periodic financial reports, or inspection rights. In the term sheet, an investor might negotiate to have rights that require the company to provide periodic financial reports and a budget to the preferred stockholders. Similarly, rights to inspect the books and records or even the company's facilities may be requested.

While some level of periodic financial reports and inspection rights are standard requests, companies may try to reduce some of the burden by having financial statements be unaudited instead of audited, limiting financial reports and inspection rights to the preferred stockholders who have invested over a certain dollar amount (called "Major Investors"), or reducing the frequency with which they must provide such financial reports (e.g., quarterly or annually instead of monthly).

4. Maintaining or Increasing Ownership

Preemptive Pro Rata Participation Rights

Another item frequently negotiated into term sheets is the right of preferred stock investors (or Major Investors) to have the ability to maintain their ownership on a pro rata basis when new securities are offered via a provision called the pro rata participation right, or commonly referred to as the preemptive right of first offer to new securities. This allows an investor to invest additional funds in future company offerings on a pro rata basis to prevent becoming diluted in their ownership.

5. Liquidity

Drag-Along; Co-Sale; Redemption; Registration Rights

Certain rights relating to liquidity may also be negotiated into a term sheet (e.g., drag-along rights, co-sale rights, redemption rights, and registration rights). Drag-along rights enable stockholders of a certain majority to force minority stockholders to join in the sale of a company. Co-sale rights (also referred to as tag-along rights) provide that if one stockholder sells their shares, the other stockholders shall also have the opportunity to sell their shares. Redemption rights allow stockholders the ability to have the company repurchase their shares. Registration rights may entitle investors holding a specified percentage of the company's registrable securities to require the company to file a registration statement and register their shares for public sale, subject to the conditions and limitations in the investors' rights agreement or such

other governing document. In some circumstances, these rights can give investors meaningful leverage regarding the timing of a potential public offering. Each of these rights can be negotiated in the term sheet phase, and some may be more important to certain investors than others.

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