FIVE KEY CATEGORIES TO CONSIDER WHEN NEGOTIATING A PREFERRED STOCK TERM SHEET

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In preferred stock financing Terms 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 key categories that should be considered when negotiating a preferred stock Term Sheet.

1. Pre-Money Valuation and Impactful 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 $5,000,000 and the investment round raises $2,000,000, then the post-money valuation will be $7,000,000.

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 percent 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 get 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 is usually included in the pre-money valuation, and this number additionally dilutes founders. The smaller the pool, the less dilution. Most investors will want to see the stock option reserve in the pre-money valuation so that they are not immediately diluted upon investing.

Founder Vesting

Investors may ask founders to add certain vesting terms to their stock (thereby becoming restricted stock and an 83(b) election should be filed) pursuant to which the founder will not be able to sell or transfer any of their stock until the vesting has completed, and if the founder leaves during the vesting period the company will have a right to repurchase the unvested shares. Some founders may try to negotiate vesting terms to be minimal or to not be subject to them at all, while some investors may require vesting terms to ensure the founders are incentivized to stick around.

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 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 like the Series A getting paid before the Series Seed who are getting 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 date like 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

The make-up 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.

Another topic in Term Sheets that is usually heavily negotiated are 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 vote for these items and depending on the length of the company's stockholder base, might not always be easy, so companies will typically try to have the list be shorter for 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.

Another form of control and governance that can be negotiated into the Term Sheet is matters that require preferred director approval. This section would state that so long as there is a preferred director the company cannot, without the approval of the board of directors which approval must include the preferred director(s), take action on a number of key 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). This section would give control and a blocking vote on certain actions to the preferred director, so each item should be carefully negotiated.

3. Monitoring Investment

There are a number of ways for an investor to monitor its investment, such as through board of director or observer roles, financial report updates 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 time intervals in which they must provide such financial reports (e.g., quarterly or annually instead of monthly).

4. Maintaining or Increasing Ownership

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 right of first offer. This allows an investor to invest additional funds in future offerings by the company so that they can prevent becoming diluted in their ownership.

5. Liquidity

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 entitle investors who own a certain agreed upon percent of the company to force the company to go public. 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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