Negotiating Term Sheets:

When to "Yes!" & How to Prepare for the Future

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Introduction

The former British Prime Minister, Harold Macmillan once said (albeit in a totally different context of the Cold War) that "[t]o jaw-jaw is always better than to war-war". However, these words do somehow ring true when considered in the context of negotiating a term sheet. A term sheet, being or representing a "memorandum of understanding", is crucial to an investment transaction as it lays out the preliminary non-binding terms and conditions (or, heads of a "commercial handshake", so to speak), based on which the definitive deal documents or agreements are later finalized and the resulting investment, made.

Typically, a term sheet lays out the details of the proposed investment including the price and valuation at which the incoming investor is investing, the nature of the instrument being subscribed to, the inter se rights of the shareholders including the incoming investor, valuation protection for the shares proposed to be issued as well as the events leading to an exit for the investor. As with all commercial agreements or documents, the above listing of the various clauses in a term sheet is merely an indicative identification of the ordinary contents of such a document; the variations in such terms, all being matters of mutual contractual understanding, are as many as the commercial human mind, on both sides, can devise and each reinforces the nature of this agreement being a "terms sheet", in essence. It forms the skeletal structure of a transaction, and records the parties' initial understanding on a non-binding basis. However, it forms an important part of the process subsequently at the time of finalization of definitive documents, as having agreed to specific terms, the parties are reluctant to deviate from the same.

In the interest of expediting execution, parties often tend to negotiate a condensed form of a term sheet. However, it is advisable to lay out the detailed terms and conditions, in order to avoid ambiguity and hence prolonged discussions when drafting the definitive documents. This also results in closure of an investment transaction in a timely and effective manner. Having said that, the procedure and dynamics of these rights and obligations can be excluded from the ambit of the term sheet and may instead be fleshed out in the definitive documents.

We have attempted to list out below, the key rights and obligations which are contained in a standard form term sheet involving a primary fund raise by a company. While the position with respect to these rights and obligations is mostly based on and derived from industry practices, some of these may vary depending on the stage at which the investee company is in its life cycle. Typically, a company raising funds from a private equity player would be a growth company, and this would afford the promoters a higher negotiation leverage in terms of their obligations. A company which is in its early stages and raising monies from venture capital players will mostly witness stringent obligations and limited rights, with the promoters being liable for most acts, as the investor decides to invest relying solely on the representations given by the promoters.

The key terms of a term sheet, together with the way they are customarily negotiated, are as follows:

1. Pre-Emptive Rights

Pre-Emptive rights, as the term suggests, is a right given to an investor to participate in a future fund raise, on the same terms and conditions as may be advanced to a potential new or further-round investor. This right is granted in order to enable the

investor to maintain its proportionate shareholding in the company and to ensure that the investor does not get diluted on account of such future fund raise. There are, as is the case with most rights, certain exclusionary events to which the pre-emptive right does not apply. These may include, amongst others, issuance of employee stock options, consolidations and share splits, occurrence of a listing event and conversion of preference shares.

This right works hand in hand with the anti-dilution and valuation protection rights, which afford the right holder the opportunity to preserve the value of its investment in the event of a down round. The recent market trends have revealed promoters' interest in retaining pre-emptive rights for themselves, in order to avoid dilution of their stakes. Retaining this right for the promoters for an early stage company might practically be futile, considering the promoters may not have the ability to effectuate such a right and participate in the fund raise. Nonetheless, it might be worth considering retaining this right for a promoter, in order to establish a precedent for a potential investor in a subsequent fund raise.

2. Board of Directors' Rights

An investor ordinarily demands a "board seat" for itself, which is in the nature of a right to appoint a non- executive director to and on the reconstituted Board of Directors of the investee company. The promoters would of course also have representation on the Board, whether themselves (which is typically insisted on by the investor as representing the promoters' "skin-in-the-game") or by way of an ability to nominate a third person to the Board. The term sheet, while capturing the Board composition, more often than not fails to contain provisions pertaining to the cessation of the Board seat, leading to much discussion at the time of the definitive documents. It is advisable to stipulate the provisions relating to removal, reappointment and fresh appointments of directors, at the time of finalizing the term sheet itself.

While the Board seat for an investor may fall away on the investor ceasing to hold a certain percentage shareholding, the Board seat for a promoter may be linked to both shareholding as well as his/her employment in the company. A standard provision would state that the promoter would lose the seat on the earlier of him/her ceasing to hold any shares or ceasing to be an employee of the company. One of the promoter considerations would be to ensure that the Board seat continues in the event of a termination of employment without cause. Considering this becomes a sticky point eventually, it is advisable to specify the understanding in the term sheet.

3. Transfer Restrictions

The premise of an investor investing in the company is that its shares are freely transferrable; at least, from a mutually commercially agreed perspective (although the law does stipulate that a private company must as a general construct, restrict the ability of its shareholders to transfer their shares). However, it is essential to provide for a 'no multiple exercise' construct. This essentially requires management and consent rights to be exercised as a block by both the investor and its transferees. This is to avoid duplicity, or rather, multiplicity of rights, and hence the consequential operational inflexibilities associated therewith, which is in the interest of both the company and the investor.

Given the fact that the promoter provides a backing to the company, the promoter's shares are usually subject to transfer restrictions. These can be in the nature of a lock-in period within which the promoter is barred from selling his/her shares. Transfer

restrictions may also include the right of first refusal ('RoFR'), right of first offer ('RoFO') and tag-along rights granted to the investor on promoters' shares. It is imperative for a promoter to negotiate liquidity for himself/herself, which can be in the form of inter se transfers amongst promoters or transfers to relatives for tax planning purposes. Another provision that is usually negotiated is the investor's RoFR or RoFO falling away upon the investor ceasing to hold a certain percentage of shares in the investee company.

While generally a RoFR is seen as investor friendly (in that the promoter who wishes to sell must 'discover' both price and prospective buyer for the investor to then consider exercising its first right to purchase or reject), a RoFO is favourable to the promoter in that the establishment of the valuation of the proposed sale is the investor's responsibility (who often will say 'no' to such a right for this precise reason as it is difficult for it to spend resources discovering such price) and the identification of the prospective buyer is differed to until the investor first decides whether or not to exercise its RoFO.

One of the most negotiated restrictions continues to be the transfer of shares to a competitor, which is barely negotiated at the term sheet stage. Given the discussions revolving around this provision, it is best to capture the understanding pertaining to a competitor restriction in the term sheet. This restriction, if agreed to be retained, should explicitly be made applicable to all shareholders and may fall away with respect to an investor on breach by the promoter or the company of the agreed terms or in an event of default situation. The mechanics of what constitutes a competitor should also be laid down in the term sheet.

4. Indemnity

Negotiating an indemnity construct, is much like a quest for the holy grail, with each party trying to secure its position in the best possible way. The company and the promoters provide the investor with certain representations and warranties which are business and title related. These representations and warranties may be given severally or jointly or both, and are advanced as of the execution as well as of the closing or completion date. The investor may also expect future looking covenants to be included, which has the effect of the company and promoters agreeing to comply with certain provisions after the closing date. The breaches of these provisions trigger an indemnity event. Once triggered, the investor may seek indemnification from the indemnifying party if such breach results in a loss in the hands of the investor. The extent and scope of the indemnification, together with the cap applicable on such indemnity, both in monetary terms as well as time limitations, should not be deferred and specifically be provided for in the term sheet as this has a tendency of souring the negotiations subsequently, with the parties insisting that the same was not agreed to in the term sheet.

All of this is easier said than done, because under Indian law the jury is still out on how an Indian court is likely to interpret a contractual indemnity clause for such breaches of representations and warranties, when the law provides for the right to rescind the contract in the case of a mis-representation and damages for breaches of warranties – the nub of the issue is whether indemnity is apposite for mis-representations or warranty breaches typically addressed in law through rescission rights and damages remedies, respectively, in a situation when the loss measure (namely, the indemnity) itself is contractually agreed. That technical question is best left to the lawyers to advise on,

depending on whether one is representing the investor or the promoter!

5. Exit Rights and Events of Default

Considering that most investors foray into a financial investment space, the exit options and their triggers are agreed to upfront. Exit may be provided at the end of an agreed period of time by way of a stock exchange listing, strategic or third-party sales, buy back (which is often seen as the last resort), etc. Sometimes there may also be a waterfall of rights, with some exit rights being given priority over the others.

Additionally, a material breach or event of default situation may also result in an acceleration of these exit rights at the option of the investor. Investors also insist upon retaining a drag along right, which allows them to force the dragged shareholders to sell their shares in the event of a material breach or event of default situation. While retention of a drag along right is perceived to be fairly standard, the concern surrounding the inter play between this right and promoter's rights cannot be emphasised enough.

Considering that this drag along right is often perceived to be a 'last resort' measure (as are buy-backs or repurchases of shares by the promoters or the company, respectively), usually the company and promoters insist that this right should only be effected upon the dragging investor selling 100% of its stake. The rationale behind this commercial imperative for the promoters is that a promoter and other shareholders should only be dragged so as to make up for the shortfall in the number of shares that the proposed buyer may be desirous of purchasing. In certain situations, an investor may not be agreeable to such a construct (for the reason that its presence may hinder the attractiveness of its sale or exit in the first place), in which case alternative exit mechanisms including buy back or put options may be agreed to in order to ensure that an investor is assured of an exit. In companies having multiple institutional investors, it may well do to lay out the specifics of a "tag within drag" scenario and the specifics of investor(s) holding a certain threshold for it to be able to initiate a drag, to ensure alignment of understanding amongst all the parties.

6. Liquidation Preference

The liquidation preference forms a vital point of negotiation in a transaction. This provision governs the priority of distribution of proceeds to the company's shareholders on the occurrence of liquidation events, such as winding up, sale of the company's assets / businesses, restructuring events like mergers, acquisitions, change in control, etc. Simply put, the investor is guaranteed payment of the investment amount, i.e., 1x (or a multiple thereof, as negotiated), in priority over other shareholders. Investors in seed rounds may settle for a 1x liquidation preference, but this may vary depending upon the stage of funding, with investors negotiating up to a 2x or 3x liquidation preference.

A key point for consideration is the type of liquidation preference: participating or non-participating. A participating liquidation preference provision permits the investor to recover the initial investment amount (or a multiple thereof), along with having the right to participate in the remnant proceeds of the liquidation event at the time of its distribution to the other shareholders. This is customarily referred to as 'double-dipping', for the investor stands to receive both, the investment amount as well as remnant liquidation proceeds when participating with other shareholders in the liquidation event. A non-participating liquidation entails the investor receiving only the liquidation preference, and not having a right to "participate" in the

proceeds of the distributions made to the other shareholders. Promoters therefore prefer a non-participating liquidation preference, while investors may insist on a participating liquidation preference.

When agreeing to the type of liquidation preference, promoters would do well to perceive its potential consequences in future rounds of investments. This means specifically agreeing if the existing investors' liquidation preference would be subject to or be *pari passu* with the incoming investor's right or if the last of the monies received will have a first liquidation preference. Another aspect worth delineating is the liquidation event itself, especially when the company has subsidiaries which might restructure in the near future. A restructuring event at the subsidiary level might, from an investor's perspective, trigger a liquidation event and may require payments to be made therefrom to the investor, making it important to outline the intention in the term sheet.

And, finally, bear in mind that a liquidation or a distribution preference occurs ideally, not when the company is wound-up but when there is an unlocking of value in terms of a transaction occurring involving the company, but then to ascertain whether the obligation to distribute proceeds lies in the hands of the company or some or all of its shareholders', respectively.

7. Cessation of Rights and Obligations

While the investors' obligations and promoter rights are typically provided to fall away on the occurrence of certain identified events, it is equally important to provide for a cessation of the promoters' obligations and investor's rights on the occurrence of certain events. This could be linked with the investor's shareholding falling below a certain threshold or an investor refusing an exit even though the same may be provided in line with the agreed terms. Recent trends have seen the promoters pushing hard for their transfer restrictions falling away as well as insisting that investor rights, including in some cases the drag along right, be subject to a certain threshold.

8. Non-Competition Restrictions

Investors seek to impose non-competition and non-solicitation obligations on the promoters. These restrictions are applicable for a defined period, however the scope is usually broad in nature and may restrict the promoter from even holding investments in public entities or passive financial investments in private companies. The promoters should consider making a carve out for these matters. Further, in the event the non-competition period is linked to employment of a promoter, it may well be a viable option to exclude the applicability of this provision in the event of a termination of employment without cause or more generally upon any termination or cessation of such employment, because the law in India is clear on the point that a post-employment restriction of such competition is invalid and unenforceable.

Conclusion

Considering that investors act as partners in the company post their investments, one must remember that the idea is to facilitate the deal while at the same time ensuring that the mutuality of interests of the various parties' on several sides are safeguarded, and risks if any, are mitigated to ensure a meaningful association. While one empathises with and understands the bitter taste that some recent developments in the private equity industry may have left, it is imperative to focus on the long-term associations and gains, and work together to

achieve the same. A well thought out and detailed term sheet can help achieve just that, having the ability to lead an investment transaction to its intended closure in an effective manner, while at the same time ensuring a friendly eco system, with the market players left to direct their energies and expertise into achieving a mutually beneficial industry.

Viewed thus, the negotiation of a term sheet is a matter of adjustment of contractual rights and obligations on the various sides of a proposed investment transaction. The key players are obviously the investors, on the one hand, and the founder or the promoters, on the other. But amidst this construct, there are various other parties whose interests are involved and who often play a vital role in concluding a term sheet negotiation -- illustratively, for instance, existing investors and key management. Ultimately, if all key players interested view the economic entity of the investee company having both rights and obligations of its own, especially under law, but also being the venue within which all other stakeholders' rights and obligations need to be adjusted to promote the economic success and stability of the company as a whole for growth and returns in the years ahead, the term sheet thus negotiated would have achieved its purposes for now and for the future.

This update has been contributed by Siddharth Raja, Senior Partner & National Executive Director, Anikta Gupta, Associate and Divya Mirlay, Associate. The update first appeared as an article in Venture Intelligence's handbook − Handbook on Venture Capital 2017.
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