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Standardized Term Sheets May Not Protect Your Interests

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Novelists stare at the blinking cursor on their blank screens. Anguished artists confront the empty canvas. Starting from scratch can be agonizing for creatives, but entrepreneurs who want to draft a term sheet or a definitive agreement for a financing don't have to wait for inspiration to strike.

Even a quick internet search yields multiple versions of documents typically used for early-stage private financings. SeriesSeed.com has forms. So do Y Combinator and the National Venture Capital Association.

These documents are often collaborations by investors, attorneys and entrepreneurs that have been fine-tuned in an attempt to create a batch of standardized forms that anyone can access point for exploring various terms and conditions. They can reduce the number of issues that you'll have to negotiate, and they can be a helpful springboard for discussions with potential investors.

But be hesitant about embracing them as an alternative to setting and negotiating terms specific to your startup's needs. These forms weren't written for your startup, so they won't necessarily protect your interests.

Let's look at documents from popular sites and see how they may inadvertently gloss over or neglect issues that can be critical to founders' long-term success.

SeriesSeed.com

The term sheet states that preferred stockholders must approve any company plans to change the authorized number of shares or authorize a new series of preferred stock on parity with the existing preferred stock. The practical implication of this language is that a company can't embark on a future round of financing without the approval of current investors.

Your current investors, who want your company to flourish, are not likely to refuse to allow you to raise capital, but why give them this option? Shouldn't you control the decisions about your next round? These investors could use the threat of a veto to negotiate for other favorable deal terms, particularly if their relationship with your company has soured.

The term sheet also states that the series seed preferred stockholders will receive the same rights as the next series of preferred stock. This provision was included to streamline the negotiations and documents related to the series seed financing by not immediately giving to series seed investors many of the rights that sophisticated investors would request in a typical preferred stock financing, such as registration rights, rights of refusal upon transfers of stock by founders, and co-sale rights to sell alongside founders who are selling their stock.

At the same time, SeriesSeed.com seeks to protect the series seed investors by guaranteeing that they will receive those typical rights down the road, when they are negotiated by other investors. However, because the clause is broadly drafted, guaranteeing "the same rights" to series seed investors as to future preferred stock investors, this language can have unintended consequences.

For example, what if a new investor is granted a board seat or observation rights to attend board meetings? Should each series seed investor receive that same right — even those who did not invest much? If new investors negotiate to receive participating preferred stock in the future, should series seed investors also receive it, even though their series seed term sheet specifies that they will receive nonparticipating preferred stock?

An experienced adviser would recommend that the series seed term sheet specify the rights that series seed investors will receive in the future, such as registration rights, rights of first refusal and co-sale rights, if those rights are granted to future preferred stock investors.

Y Combinator

The Silicon Valley-based accelerator's online documents include a SAFE, or simple agreement for future equity. A SAFE is an investment made today that converts into stock at the time of a future financing or exit event. Y Combinator offers four SAFE options, reflecting whether you include a "most favored nations" clause and a discount, a cap, or both.

As written, Y Combinator's sample SAFE requires the company to obtain the consent of each SAFE holder to amend that particular SAFE. On the surface, that is logical — so many founders wouldn't give this a second thought.

However, most early-stage companies that will use the SAFE will issue more than one of these investment agreements because they typically raise relatively small amounts of capital from several investors. So without altering the amendment requirement as written, the company will need the consent of every single SAFE holder to amend the terms of all SAFEs.

This unanimity requirement can present a problem if you want to change the terms of all SAFEs (such as to amend the discount or cap) but one or more of your small investors refuse to go along. An experienced adviser would recommend more company-friendly language that requires only a majority vote by SAFE holders, not a unanimous one.

NVCA

The National Venture Capital Association provides a free and comprehensive trove of model legal documents for a preferred stock financing, including a term sheet and the principal definitive documents — stock purchase agreement, certificate of incorporation, investor rights agreement, voting agreement and right of first refusal, and co-sale agreement.

These forms are helpful, but which of the three alternatives for dividends should you choose? And should you include participating preferred stock, nonparticipating preferred stock, or participating preferred stock with a cap? What are the implications of your choice? And which is most typical?

It's tempting to shrug these types of decisions off as insignificant, particularly if you're satisfied with the pre-money valuation and investment amount you negotiated. But the decisions you make today can have long-term implications for your startup, future funding rounds, and the sale of your company. If you quickly agree to provisions that favor your investors, you can unknowingly deprive yourself of sale proceeds.

I'm not suggesting that you reinvent the wheel when you need to raise capital. The many investors, entrepreneurs and attorneys who have been down this road before have shared forms, so take advantage of them.

Just never assume that a crowdsourced document will satisfy all your concerns. Every business has a unique set of circumstances, and the documents that govern your company and its future should be tailored to your particular needs.

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