

VENTURE CAPITAL
DEAL TERMS

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**A GUIDE TO NEGOTIATING
AND STRUCTURING VENTURE
CAPITAL TRANSACTIONS**

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PREFACE

In 2004, a renowned Dutch professor, whose university-based company we were spinning out, asked me to explain exactly what I was asking him to sign. On his desk lay a term sheet I had drafted. Pressed for time, I promised to provide him with a written explanation of the most important terms.

I quickly realised, however, that a literal explanation of the terms alone was insufficient to convey their implications in various scenarios—scenarios that often only materialise years later, such as during an exit. This realisation inspired me to write a book rather than merely summarise the terms. I began writing immediately, but balancing a full-time job with this new endeavour proved more challenging than I had anticipated. After five months of late nights and weekends spent scribbling, I asked my good friend, Menno van Loon, to join me. Menno and I had taken the bar exam together years earlier, and his experience as both a lawyer and an investment banker proved invaluable. Together, we completed the book in twelve months and published it in 2005.

Over the following decade, I launched new funds and invested in numerous high-tech companies. The banking crisis came and went, reshaping the venture capital landscape. Specialised lawyers founded niche law firms focusing on venture transactions. One of these specialists, Sjoerd Mol, pointed out that our 2005 book was becoming outdated and that a broader, more practical treatment of venture capital deal terms was needed. Menno, Sjoerd, and I accepted that challenge. The result was the 2015 publication of a new book, *Venture Capital Deal Terms*.

A decade later, the venture capital landscape has evolved once again, prompting us to create this second, fully revised, edition of *Venture Capital Deal Terms*. Beyond merely updating content, we have enriched the text with practical insights gained from countless transactions over the past ten years. Most notably, we've introduced targeted practical tips sections throughout Chapter 4, designed to help stakeholders navigate negotiations efficiently and avoid common pitfalls. Our aim remains unchanged: to provide a genuinely valuable resource that bridges the knowledge gap between entrepreneurs and investors, enabling more transparent and productive collaborations that ultimately lead to mutual success.

Harm de Vries

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1 INTRODUCTION

Venture capital has established itself as an important source of funding for companies, ranging from startups to more established businesses. Consequently, the number of people involved in venture capital transactions at some point in their careers is steadily increasing. While some participants in venture capital transactions possess extensive venture capital experience, others have only a basic grasp of its key concepts and practical applications. Entrepreneurs whose companies receive venture capital investments, lawyers new to this field, and even junior venture capitalists and angel investors often lack a comprehensive understanding of all aspects of venture capital financing needed to ensure a successful transaction.

The purpose of this book is to provide a clear understanding of the most commonly used practices, terms, and conditions to those with less than extensive experience in venture capital transactions. However, we believe this book will also be a valuable reference guide for experienced venture capitalists.

Practically all venture capital transactions begin with the execution of a term sheet. A term sheet is a document summarising the basic terms and conditions under which investors are prepared to make an investment. It also outlines the transaction structure, the parties involved, timelines for due diligence, and the closing deadline. A well-drafted term sheet helps focus the parties on the essential elements of the investment and determines whether there is common ground on key investment conditions before spending further time, energy, and money on negotiations. A term sheet covers the main aspects of a venture capital financing and facilitates the execution of the final transaction documents.

Effective participation in term sheet negotiations is possible only if each party fully understands the terms (including their commercial implications), the information provided, and possible alternatives. Furthermore, a clear understanding of these terms will likely expedite the negotiation and completion of the investment process. We hope this book will help in gaining such understanding, benefiting all parties involved.

1.1 STRUCTURE OF THE BOOK

This book is intended as a practical, easy-to-use guide. In *Section 2* of this chapter, we first discuss the investment process in general. In *Chapter 2*, a fictional venture capital transaction serves as the basis for discussing the different clauses commonly used in term sheets. *Chapter 3* contains the term sheet submitted to the company raising an investment round in the transaction described in *Chapter 2*. This term sheet serves as the foundation for *Chapter 4*, which addresses specific subjects from the term sheet (e.g. liquidation preference, anti-dilution protection, drag-along, and tag-along). Each section of *Chapter 4* examines a specific type of clause commonly found in term sheets. It provides a standard version of each clause (as used in our Term Sheet template set forth in *Annex 1*) alongside alternative versions where applicable. Additionally, it offers practical tips.

Annex 1 contains our complete Term Sheet template. *Annex 2* sets forth the profit and loss statement and cash flow statement for the fictional venture capital transaction discussed in *Chapter 2*. *Annex 3* includes a glossary of terms frequently used in venture capital transactions for easy reference. *Annex 4*, finally, contains an IRR analysis.

Throughout *Chapter 4*, we provide practical tips following each clause discussion. These tips offer actionable advice drawn from our extensive experience in venture capital transactions. To complement these section-specific recommendations, we've compiled several foundational principles below that apply universally across term sheet negotiations. By presenting these overarching guidelines here, we avoid redundancy while emphasising their importance. We encourage readers to reference these general principles as they explore the specific clauses and considerations detailed in subsequent chapters:

- Prioritise simplicity and clarity in all agreements. Complex structures often lead to misunderstandings and disputes that could have been avoided through straightforward language and design.
- Use precise, measurable terms rather than vague references. Instead of mentioning 'market validation', specify concrete metrics such as 'securing contracts with [X] customers' or 'achieving [Y] revenue'.
- Ensure interdependent clauses are harmonised to prevent conflicts or unintended consequences. Terms governing voting rights, liquidation preferences, and anti-dilution protections must work cohesively rather than at cross-purposes.

- Remain realistic when negotiating terms. Overly ambitious goals or unrealistic provisions can strain company operations and ultimately jeopardise all stakeholders' positions.
- Maintain open communication with all stakeholders, ensuring transparency about how agreed terms will function in practice. Misaligned expectations often lead to disputes during critical moments such as down rounds or exits.
- Structure clauses to align interests across all stakeholders early in the process. Whether through anti-dilution protections, vesting schedules, or milestone-based financing, cultivating genuine collaboration is essential for long-term success.
- Always assess how terms might impact future fundraising rounds. Overly restrictive provisions or disproportionate protections can deter new investors or unnecessarily complicate subsequent negotiations.
- Plan for contingencies such as founder departures, down rounds, or strategic pivots. Addressing these possibilities upfront saves considerable time and prevents potentially damaging disputes later.
- Establish regular review mechanisms that prompt the company to periodically assess key matters agreed upon in the documentation. This practice ensures appropriate action when initial assumptions are overtaken by changing realities.

By keeping these overarching principles in mind, readers will be better equipped to approach each section of the book with a holistic perspective, ensuring the terms they negotiate not only address immediate priorities but also support long-term growth and stability.

1.2 INVESTMENT PROCESS

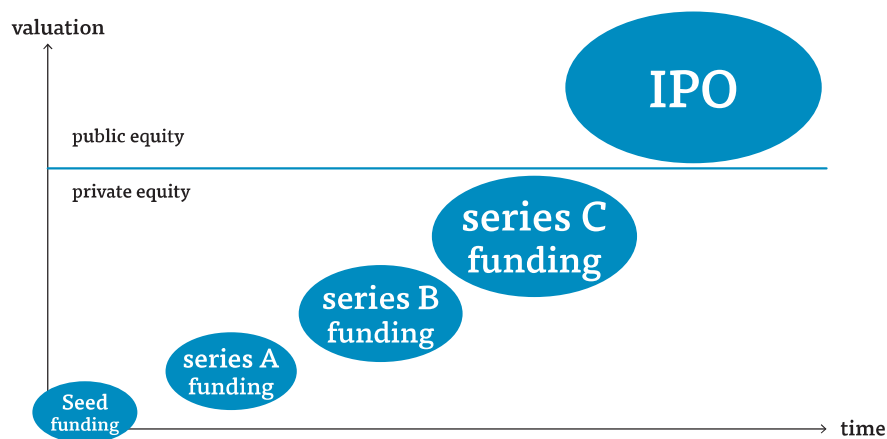
Venture capital firms invest in companies with high growth prospects, allowing them to earn returns upon exit by selling their shareholdings in those companies to another company (*trade sale*) or to the public (through an *initial public offering* or *IPO*). Venture capital firms usually retain their investment for a period of three to seven years. This period often depends on the company's stage, growth profile, and exit opportunities. The stages a venture-backed company goes through in chronological order are generally referred to as *Seed*, *Early*, and *Growth*.

The chance that a company will fail to realise its business plans within the set time frame is considerable. To limit their financial risk, venture capital firms invest in companies in multiple rounds, rather than providing the

total investment required from the outset. Staging capital contributions through different investment rounds allows investors to assess the company's progress in terms of value increase before each new round and enables them to take timely measures if the company's viability is at risk. This approach not only mitigates potential losses but also provides flexibility to reallocate resources to more promising opportunities. If the company's value increases, multiple rounds make it possible to issue equity at a higher price in each round, enabling shareholders to capitalise on the progress achieved between rounds.

The time between rounds depends on the time required for the company to achieve value-increasing milestones (see *Chapter 4, Section 3: Milestones*) and typically ranges from one to two years. Over time, the *burn rate* (the rate at which the company uses its available funds) tends to increase, meaning more funds will be needed to bridge an additional period of similar length. Consequently, as the company matures and investment risks generally decrease, investors are typically willing to commit larger amounts in later rounds.

FIGURE 1: VENTURE CAPITAL INVESTMENTS



Investors participating in each round of financing will negotiate terms reflecting the specific investment risks they perceive. Typically, they will not accept terms less favourable than those negotiated in earlier rounds. Most of the rights negotiated in a financing are attached to the (*preferred*) shares issued in that round. To distinguish between these rights, each round typically has its own *series* (*class*) of shares, starting with Seed

funding, followed by the Series A investment round, and continuing as needed until an IPO or acquisition occurs.

In practice, the investment process can be time-consuming and costly. Legal expenses often form a large part of the costs involved. More often than not, these costs will be higher than anticipated. The best way to avoid excessive legal fees is to be well-prepared. Only involve a lawyer when they provide true added value. Take your time selecting a lawyer with solid venture capital experience—you don't want to pay a lawyer for their on-the-job learning experience.

If you are planning a venture capital transaction in a country where you have not been active before, it is important to ensure support from knowledgeable advisors. Failing to do so can result in costly misunderstandings due to legal or other differences between your usual jurisdiction and the foreign jurisdiction.

The time required to raise money varies, but generally speaking the entire process—from the first meeting with a venture capitalist to closing—takes four to eight months. Venture capital investors usually want to assess a company's performance over time rather than basing their decision on a snapshot. Therefore, the advice for startups is: start meeting with venture capital investors as soon as possible. Since the time between rounds is typically no more than one or two years, investor engagement should be a continuous activity for any startup CEO.

FIGURE 2: LIFE CYCLE OF STARTUP

