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What to Expect and to Avoid in Term Sheets

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David Frankel, Founding Partner at Altirah Capital, offers his advice about what entrepreneurs should expect and what they should avoid in the term sheets offered by VCs when raising money. Frenkel suggests that entrepreneurs should expect VCs to have liquidation preferences, pre-emptive rights, first refusal rights, anti-dilution rights, board member seats, CEO replacement rights and full disclosure. In contrast, Frenkel suggests entrepreneurs should not accept a big valuation from an individual investor who cannot follow on or ?traditional terms? that are not adequately explained and justified.

Transcript

Some of the things that you should expect, in terms of the term sheet, is you should expect liquidation preferences. You should expect the fact that a venture capitalist, if things go wrong, are going to try and get out whatever they can which generally is very little. You should expect pre-emptive rights, the rights for the funder to follow on if they want to and if things aren't going positively. You should expect rights of first refusal. You should expect anti-dilution rights. So if you funded a certain pre-money and things go wrong and there's an option to fund at a lower amount, the venture capitalist, the capital provider, is going to ensure that they are not unfairly diluted. You should absolutely expect your partner to want full information rights and to understand your business well. One of the things I would say is at the outset, disclosure is...it was lovely in the analogy used earlier,but make sure that you understand as much about each other. You wouldn't marry someone that you picked up in a bar. So, on the other side, disclose everything you can.

Make sure that if things go wrong, you did your best to make sure that that doesn't come as a surprise. So many of these relatively good marriages break up for the wrong reasons. So I would say, full disclosure is incredibly important. The right to appoint board members, and something that's usually quite thorny, is the right to replace the CEO. Talking to this kind of forum which is so entrepreneur and founder-centric, that's a tough thing to say but often you start to need to think like a shareholder. In two or three situations now, we have opposed the venture capitalist in terms of replacing the CEO either because we thought it was premature or because we thought that the candidate wasn't good enough. But if you can find an outstanding candidate who's been there, done that before, there comes a time when potentially you need to start thinking as a shareholder. The kind of things that you shouldn't accept in my view, is a big valuation from an initial funder who could be a high net worth individual or an angel but someone who can't follow on. It's kind of what Jason said earlier is when you're going out to raise funding, you're in the best position if you don't need that funding. You're in the best position if you can say, "You know, our seed investor is very happy to follow on here or bridge us to the next round." So taking just the highest pre-money, the highest valuation that you could find with no follow on capacity in my view is an absolute no-no.

It is an interesting discussion is do you take as much as you can get? Again, in my experience, and it was mentioned earlier, is sometimes taking too much money is not a good thing either because if it's no longer a scarce resource and that means bad things in terms of how you run your business. It just goes without saying, responses such as when you ask about a

term and a response such as, "Well, this is a traditional term" or handwriting responses, you should never ever put up with. You should always diligence that and check if it really is. Finally, if it's something milestone-funded, if it's being funded in milestones, make sure that you are very conservative and you articulate those milestones really well.