The Recent Development of the Venture Capital Term Sheet

A Substantive Analysis of the Impact of the ‘New Venture Capital Cycle’ on the Terms and Conditions of Venture Capital Contracting

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Abstract

This paper examines the recent trends in the venture capital industry and their impact on the terms and conditions of venture capital contracting. The claim is being made that recent changes and developments in the venture capital industry, that altogether caused the emergence of the 'new venture capital cycle', have resulted in a shift towards more entrepreneur-favorable deal terms in venture capital term sheets. The data used in this paper highlights that the numbers, magnitude and content of certain key-provisions of the term sheet appear to be moving more and more in the direction of the entrepreneur. Additionally, a new breed of investors such as online crowdfunding platforms and incubators and accelerators, that offer more easily accessible 'venture capital', have provoked the appearing of non-jargony term sheets and self-imposed venture capital codes of conduct. Finally, hampering IPO-markets and the rising popularity of the trade sale as preferred exit strategy pose some real challenges to venture capitalists: they will have to compensate for the lack of entrepreneurship-enhancing incentives that derive from the fact that an IPO as exit event has become unavailable (and undesirable?) in most cases.

Keywords: venture capital, IPO, new venture capital cycle, term sheet, trade sale, corporate venture capital, crowdfunding, super-angels, incubator, accelerator, entrepreneur-favorable, incentives, liquidity gap, non-jargony term sheet, venture capital code of conduct, secondary markets

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Introduction

The last decades have been recognized as a period in which extremely successful venture capital backed firms have emerged. Many of the most flourishing high technology companies of the last decades in the US, including Apple Computer, Cisco Systems, Genentech, Microsoft, Netscape and Sun Microsystems, have been backed by venture capitalists.[1] Amongst more recent examples of venture capital-backed "homeruns" are globally renowned companies such as Google, YouTube, Spotify, Skype, Amazon and Facebook. The latter's recent acquisition of messaging company WhatsApp for $19 billion represents another excellent *exempli gratia* of a venture capital-backed success story. One of WhatsApp's founders, an immigrant from the Ukraine named Jan Koum, used to life on food stamps and was turned down for a job at Facebook several times, before he and his business partner Brian Acton started the company less than five years ago. In addition to making both men billionaires, Facebook's acquisition marks an enormous windfall for Sequoia Capital, the only venture capital firm that backed these ambitious entrepreneurs when they founded WhatsApp. Sequoia invested about $60 million for a stake valued at up to $3 billion in the deal.[2] This means it received an astonishing return of almost 5000% on its initial investment. This story sounds like a modern fairy tale, doesn't it?

And there is more good news: 2013 was a solid year for the venture capital industry, and worldwide investments rose to $48.5 billion. Investments were not only soaring in the United States, the cradle of venture capital, but in other parts of the world as well. In Europe, venture capital markets saw a remarkable rebound, with the amount of capital invested and the number of deals rising respectively 19 and 6 percent, while venture capital industries in countries like India, Israel and Canada showed a strong performance as well.[3] Additionally, the rapid growth of venture capital markets in emerging economies like Russia, Brazil and Mexico makes you believe that venture capital has some bright years to come.

However, it is not all rainbows and sunshine. On the contrary, traditional exit markets (i.e. IPO's) have been performing sluggishly over the last decade, and most traditionally structured venture capital firms have delivered uninspiring returns.[4] Despite the souring markets of the last years, the fact that since the burst of the dot-com bubble in 2001-01 more venture capital has been invested in start-up

[1] *Gompers, P. and Lerner, J.; 'The Venture Capital Revolution', Journal of Economic Perspectives, 2001, Vol. 2.*

[2] *'Facebook to pay $19 billion for WhatsApp', WALL STREET JOURNAL, 19 February 2014.*

[3] *Ernst&Young; 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.1-2.*

[4] *Mulcahy, D.; 'Six Myths About Venture Capitalists', Harvard Business Review, May 2013.*

companies than returned to investors, makes venture capital a relatively unattractive asset class for institutional investors.[5]

These depressing figures have not only caused a significant decrease in the number of venture capital funds, but have led many venture capitalists towards the less risky financing of later and growth stage companies.[6] This more conservative way of investing has created a ‘funding’ gap in the earlier stages of the corporate life cycle. This ‘funding’ gap is currently filled by ‘new’ categories of investors, such as online crowdfunding platforms, multinational corporations and so-called “super-angels”. [7] In addition to the emergence of this ‘new’ breed of investors, new exit opportunities have attracted an increasing amount of attention from investors, entrepreneurs and regulators. Secondary market venues have emerged on a global scale, while trade sales have become the preferred exit strategy for most venture capitalists – thereby replacing the once-dubbed ‘golden standard’ of venture capital: the IPO.

As a consequence of the aforementioned developments, the venture capital cycle has been changing to an extent that has caused some scholars to talk about a ‘new’ venture capital cycle.[8] And while the catalysts and consequences of the emergence of this new cycle have been extensively discussed in the literature, its effect on the relationship between entrepreneur and venture capital investors has not yet received such scholarly scrutiny. This paper aims to partly ‘fill’ this gap in the respective literature by having a closer look at the documents and mechanisms governing and influencing this relationship. However, due to the fact that discussing the entire entrepreneur-investor relationship - from initial investment-negotiation until final exit event -would be a little too extensive, this paper mainly focuses on one of the most important legal documents outlining the parties’ intentions and governing their agreement to invest: the venture capital Term Sheet.

[5] *Mulcahy, D., Weeks, B. and Bradley, H.; ‘We Have Met the Enemy…and He is Us: Lessons from Twenty Years of the Kauffman Foundation's Investments in Venture Capital Funds and the Triumph of Hope Over Experience’, May 2012.*

[6] *Dittmer, J., McCahery, J.A. and Vermeulen, E.p.M.; ‘The ‘New’ Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms’, November 20, 2013.*

[7] *European Venture Capital Association; ‘Smart Choice: The Case for Investing in European Venture Capital’, 2013.*

[8] *Mendoza, J.M. and Vermeulen, E.P.M.; ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity’, May 3, 2011.*

Research Question

The importance of a well-drafted term sheet for both entrepreneurs and venture capital investors cannot be overestimated. We have all heard the success stories of inexperienced entrepreneurs that start a business - and develop their innovative ideas – in tiny student-dorms or dusty basements and manage to build it into a global market leader. However, in reality things are much more complicated. It takes a lot of dedication, brilliance, help and even dumb luck to make an excellent idea into a successful business, and only one in thousands of innovative business ideas manages to become the wished-for market leader. Both entrepreneurs and investors are aware of this very small chance of success, and the fact that the investment term sheet plays a crucial role in increasing their prospects of a prosperous future. It may therefore be no surprise that the term sheet is heavily negotiated and as a consequence is influenced by the parties' bargaining power and preferences.

As a result of the current economic situation and new developments within the global venture capital industry (the aforementioned 'new' venture capital cycle), it is very likely that both entrepreneurs´ and investors´ bargaining power and preferences have changed slightly over the last couple of years. This paper analyzes the impact of these developments on the term sheet and provides a brief overview of the most notable changes.

The most important processes that are changing the venture capital industry will be discussed extensively. In order to be as comprehensive and up to date as possible, much more than merely academic sources will be analyzed. More importantly, this paper will have a close look at what is currently rumbling the world of venture capital. Trend reports from venture capital associations and other business insiders, online blogs from renowned investors and articles about the most recent developments: they will all be considered thoroughly. In addition to that, the impact of all significant recent developments on the term sheet will be examined. What is the effect of the emergence of 'new' investors such as crowdfunding platforms, super-angels and incubators and accelerators? Have certain deal terms changed considerably as a consequence of the emergence of secondary markets? And what is, if any, the impact of the declining popularity of the IPO as the preferred exit strategy on the content of the term sheet?

In short, this paper tries to answer the following question:

"How is the term sheet being influenced by the 'new venture capital cycle'"?

This main research question, supported by the aforementioned sub-questions, will serve as a guideline throughout this writing. However, its content reaches far beyond merely providing answers to these questions. In order to provide a comprehensible analysis of the current state of the term sheet the different features and processes that define the venture capital industry will be discussed as well. The first chapter kicks off by briefly describing the most important characteristics of 'traditional' venture capital. After that, the second chapter elaborates on the two most important exit strategies: the IPO and the trade sale. The third chapter analyzes the recent developments that have partly caused the emergence of the 'new' venture capital cycle: the sluggishly performing exit markets, the entrance of 'new' investors and the increasing popularity of new exit strategies. The fourth chapter provides an overview of the most important components of the venture capital term sheet and the fifth chapter will discuss the impact of the 'new venture capital cycle' on the term sheet. Finally, chapter six will conclude.

Chapter I: Traditional Venture Capital Investors

1.1. Venture Capitalists

Venture capital is 'formal' or 'professional' equity, in the form of a fund run by general partners, to invest in a large number of highgrowth companies from their early stages to their more mature stages.[9] The venture capital firms that run these funds – venture capitalists – are often described as 'professional managers of high risk capital offering financial and other support to the most promising and innovative start-up companies'.[10]

Venture capitalists generally fund innovative and new ideas that - due to the high amount of risk and uncertainty involved - cannot obtain traditional bank financing. In order to spread the risk involved with the funding of high-growth start-up companies, venture capitalists normally invest in a large portfolio of companies. Typically, the amount of capital that is initially invested by venture capitalists ranges from two to ten million dollars, while the entire amount of capital invested by venture capitalists around the world in the year 2013 equaled almost fifty billion dollars in a total of more than five thousand investment rounds.[11]

As an institutional investor asset class, venture capital is quite unique in the sense that money is used to make an equity investment in a company whose stock is highly illiquid and essentially worthless at the time of the investment.[12] It takes some time – normally five to eight years – for the company to mature. As the company is growing, additional finance is provided through follow-on investments, called 'rounds'. These rounds, typically occurring once in two years, are equity investments as well. The shares are allocated among investors and the managers based on an agreed "valuation" of the company in case. But unless the company is acquired or conducts an initial public offering, there is not much actual value. Therefore, it is fair to say that venture capital is a long-term investment with some significant risk involved.[13]

Traditionally, venture capital is being invested in companies in the fields of new technologies (such as software, IT services and biotechnology, see figure I) and thus rapidly developing, or companies where market or operational inefficiencies can be improved thereby enhancing the competitive situation of existing businesses.[14] It is an important source of funding for young, technology-based

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[9] *Wilson, K.E.; 'Financing High-Growth Firms: The Role of Angel Investors', December 22, 2011.*

[10] *National Venture Capital Association, 'Yearbook 2014', 2014.*

[11] *Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014'*, January 2014, p.1.

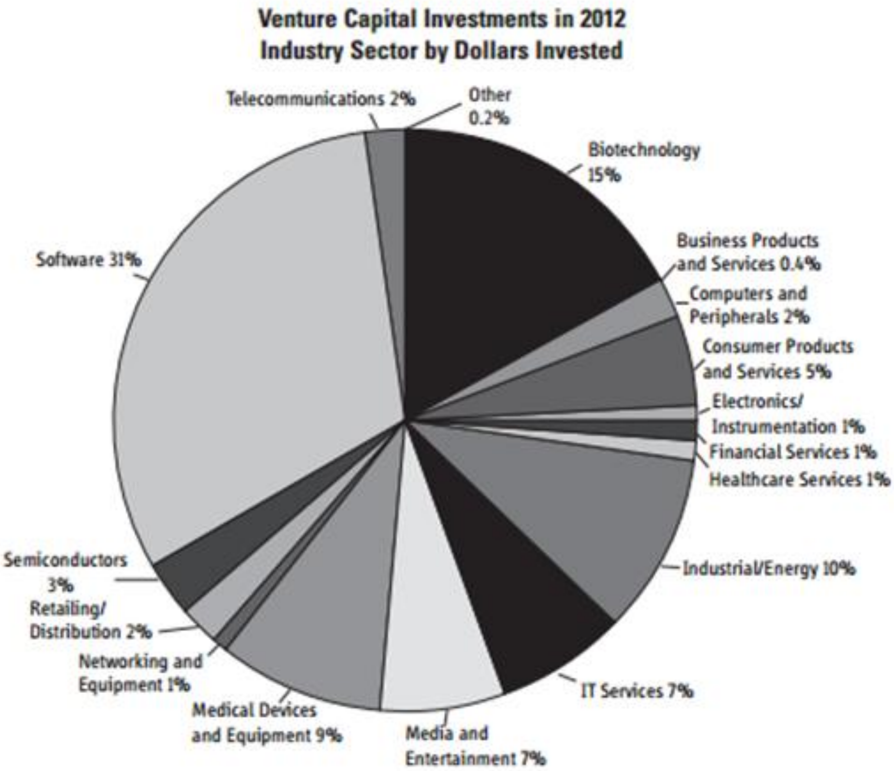
[12] *National Venture Capital Association, 'Yearbook 2014', 2014.*

[13] *National Venture Capital Association, 'Yearbook 2014', 2014.*

[14] *Wilson, K.E.; 'Financing High-Growth Firms: The Role of Angel Investors', December 22, 2011.*

firms and has played a key role in industries such as ICT. Moreover, venture capital is widely credited for the development of entirely new industries, such as microcomputer software and biotechnology.[15]

Figure I



In the last decades, many of the most successful high technology companies, like Microsoft, Apple, Google and Facebook, have been backed and supported by venture capitalists.[16] However , venture capital is not merely of interest for technological companies – Starbucks, Staples and Whole Foods Market are among the examples of non-high tech venture capital backed success stories.[17]

A clear distinction between two types of venture capital funds can be made: captive venture capital funds and independent venture capital funds. Captive venture capital funds are funds that have been established by corporations, banks, pension funds, insurance companies or even by the government. These funds are established in order to serve the interests of their respective 'parent organization' and therefore are called 'captive'. Captive venture capitalists are funded by their parent organizations and as a consequence do not have to seek funding from different outside sources. This contrasts with independent venture capital funds.[18] Independent venture capital funds are provided by institutional

[15] *Mason, C.M. and Harrison, R.T.; 'The Size of the Informal Venture Capital Market in the United Kingdom', Small Business Economics , 2000, vol. 15.*

[16] *National Venture Capital Association, 'Yearbook 2014', 2014.*

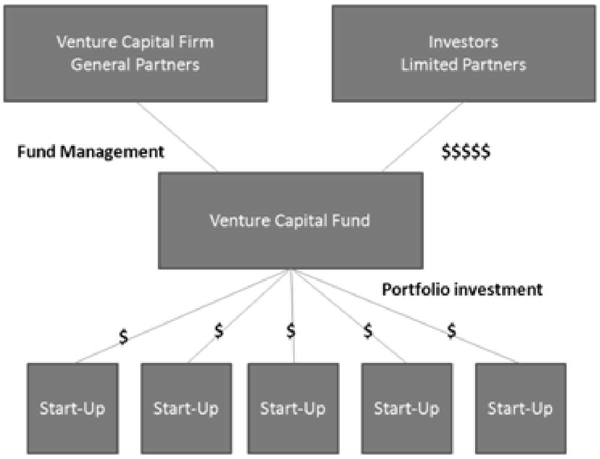
[17] *National Venture Capital Association, 'Yearbook 2014', 2014.*

[18] *Gregoriou, G., Kooli, M. and Krauessl, R.; 'Venture Capital in Europe', Elsevier Finance, 2007.*

and private investors that are interested in investing in innovative start-up companies.[19] Institutional investors that normally invest capital in venture capital funds are pension funds, endowments, fund of funds, banks, insurance companies and can also include high net worth individuals and family offices, while private investors mostly consist of high net-worth individuals.[20]

This institutional investment makes it possible that funds are pooled for investing in a large group of innovative entrepreneurial ventures (the co-called 'portfolio companies', see figure II) and are managed by experienced fund managers with both the experience and incentives to invest in and support high-growth companies. In the industry, these independent venture capitalists are named "general partners", while the investors that merely commit capital to the fund are called "limited partners".

Figure II



The general partners' compensation generally derives from two sources (the so-called 'two and twenty' arrangement).[21] First, around 2% to 2.5% of the total amount of committed capital is generally collected by the fund's managers as an annual management fee. A second source of compensation for the general partners is the so-called carried interest: typically, the general partners earn on average around 20% carried interest on the net profits made by the fund.[22]

Collecting these fees enables venture capital funds to cover their operating costs and gives them the possibility to hire professional managers to run the fund in order to maximize profits. However, the aforementioned 'two-and-twenty' compensation arrangements have been increasingly under pressure after the financial crisis. Investors are more and more convinced that these rules do not sufficiently ensure a proper alignment of interests and incentives between managers and investors, and therefore

[19] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.*

[20] *European Venture Capital Association, 'Creating Lasting Value: Annual Report 2010'.*

[21] *McCahery, J.A. and Vermeulen, E. P.M.; 'Recasting Private Equity Funds after the Financial Crisis: The End of 'Two and Twenty' and the Emergence of Co-Investment and Separate Account Arrangements', November 8, 2013.*

[22] *McCahery, J.A. and Vermeulen, E. P.M.; 'Recasting Private Equity Funds after the Financial Crisis: The End of 'Two and Twenty' and the Emergence of Co-Investment and Separate Account Arrangements', November 8, 2013.*

sometimes demand for higher capital contributions by the general partners. This is called 'more skin in the game'.

After capital is committed by the limited partners, the funds are directly invested in a group of innovative start-ups, the portfolio companies (see figure II). Venture capitalists usually invest in a large number of companies, understanding that only some will succeed, while the rest will fail or have a mediocre performance.

However, venture capitalists do not only provide these companies with capital, but actively support their development as well. Different ways in which venture capitalists help their portfolio companies grow and foster include the identification and evaluation of business opportunities, playing an active role on the firm's board, coaching the firm's founders, providing management and technical assistance, attracting additional capital, directors, suppliers and other key stakeholders and resources.[23] These value-added services play a very important role in increasing the prospects of success of highgrowth start-up companies and therefore this active support by venture capitalists is widely believed to play a crucial role in enabling entrepreneurs to make their innovative business idea into a matured and successful company.

Some of the most renowned and successful venture capitalists around the world are Kleiner Perkins Caufield & Byers (US, funded Google, Amazon and Electronic Arts), Accel Partners (US, funded Facebook and Spotify) and Wellington Partners (EU, funded ACG and Webmiles).

1.2. Angel Investors

Despite the fact that the term sheet used by venture capitalists is the main subject of this paper, angel investors play a very important role in the venture capital cycle as well. Therefore, the most important aspects of angel investors will be discussed briefly in this paragraph.

A traditional angel investor (hereafter: 'business angel') is a high net worth individual that involves him- or herself in the highgrowth start-up companies he or she is funding. Most of the times, angel investors invest money and business experience in these early-stage start-ups in return for stock. Normally, start-ups in the earliest stage are mainly financed by founders and founders' friends and family. At a certain point, the liquidity provided by the founders and their inner circle doesn't suffice anymore, and new investment has to come in. On most occasions, the company will not be mature enough for venture capitalists, and as a consequence the start-up has to overcome a gap in its financing. This gap is called the first investment or financing gap (or sometimes the 'Valley of Death') and can be filled by business angels, who tend to operate in the segment that falls in between informal founders, friends and family financing, and formal financing by venture capitalists (see figure III).[24]

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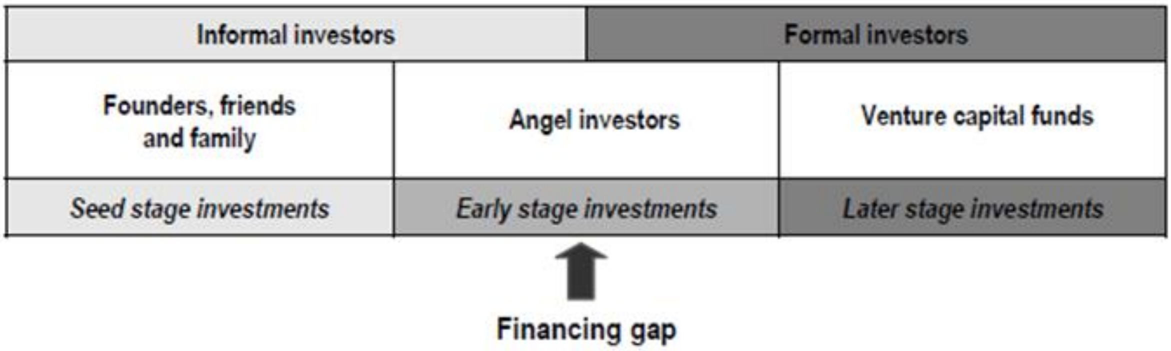
[23] *McCahery, J.A. and Vermeulen, E.P.M.; 'Venture Capital Beyond the Financial Crisis: How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts)', May 29, 2010.*

[24] *Freear, J. and Sohl, J.; 'The Characteristics and Value-Added Contributions of Private Investors to Entrepreneurial Software Ventures', Journal of Entrepreneurial Finance, 2001, vol. 6.*

Figure III

Equity investors at the seed, early and later stage of firm growth



Like most venture capitalists, business angels do not only provide finance but value-added services as well. Because of the fact that most business angels have previously been successful entrepreneurs, they can involve themselves in the company's operations, thereby contributing important business knowledge, experience, skills, expertise and connections. [25] As a consequence, business angels can significantly enhance the company's prospects of success by guiding it through the early stages of its development.

In short, by providing financing as well as business expertise, angels help filling the equity gap as well as the knowledge gap of young and innovative start-ups, while making these companies grow until they reach the point at which they become attractive investments for venture capitalists.[26] This important role of business angels is often underestimated and underappreciated: while venture capital investors are credited and praised for most Silicon Valley success stories, people tend to forget that a lot of successful businesses relied on angel-financing before venture capitalists noticed their potential. Bell, Ford Motors, Microsoft, Amazon and Google: they all had funding from angels.[27]And what if California-based angel investor Mark Markkula would not have had provided Steve Jobs with funding for his first ideas? Apple Computers would probably have never had become the incredibly successful global market leader it is today.

However, this climate of ignorance towards the merits of angel investors is changing, and angels are nowadays increasingly recognized as an important source of capital at the seed- and early-stages of the company lifecycle.[28] Currently, business angels are commanding larger pools of capital than ever before and are better organized, making them more visible to entrepreneurs in search of capital. Globally, their investments are expanding, and over the last couple of years angel participation has

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[25] *Ibrahim, D.M.; 'The (Not So) Puzzling Behavior of Angel Investors', Vanderbilt Law Review, 2008, Vol. 61 p.1419.*

[26] *Ibrahim, D.M.; 'The (Not So) Puzzling Behavior of Angel Investors', Vanderbilt Law Review, 2008, Vol. 61 p.1418.*

[27] *Sudek, R., May, A. and Wiltbank, R.; 'Angel Investing: Catalyst for Innovation', Angel Research Institute, October 2011.*

[28] *Mason, C.M. and Harrison, R.T.; 'The Size of the Informal Venture Capital Market in the United Kingdom', Small Business Economics (2000), vol. 15.*

grown significantly in the US (from 13,7% in 2007 to 25,5% in 2013) and Europe (from 4,6% in 2007 to 26,8% in 2013), while countries like China, India and Israel saw an increase in angel participation as well.[29] Based on the foregoing, it is fair to say that business angels have become a more significant and recognized force in the world of venture capital over the last couple of years, and it seems likely that their importance will continue to grow in the near future.

1.3. Angel Syndicates or Groups

Other than the traditional angel investor, who is normally acting all by himself, angel investors have increasingly formed syndicates and groups over the last couple of years. The number of angel groups and syndicates is growing mainly because of a rising demand from entrepreneurs for syndicated deals to fill the market gap between investment by individual business angels and venture capitalists.[30] Investing through groups has some advantages for both business angels and entrepreneurs. First, it allows business angels to discover a wider range of companies they can potentially invest in, and it gives them the opportunity to identify other angels that can potentially become co-investment partners.[31]

In addition to this, another important driver behind the increasing emergence of angel groups and syndicates, is the fact that these groups of business angels are better able to fill the so-called ‘second investment gap’ (or ‘Second Valley of Death’). As a consequence of pooling their investments, angel groups are better able to meet the larger capital requirements that are currently needed by entrepreneurs.[32]

As will be explained more thoroughly in the third chapter of this paper, over the last years the venture capital industry has shifted to the less-risky financing of more mature start-up companies, thereby creating a second investment gap in the venture capital cycle. Due to the fact that individual business angels normally invest amounts of up to $2 million, and the venture capital market has adopted the strategy of later-stage start-up financing (starting from around $5 million), entrepreneurs are left with a financing gap that has to be bridged.[33] And this financing gap can be better filled by angel syndicates or groups.

Additionally, angel groups can add more value to the companies they invest in (ex-post) due to the fact that they can offer better value added services that can drastically increase the prospects of success of

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[29] *Ernst&Young, ‘Adapting and Evolving: Global Venture Capital Insights and Trends 2014’, January 2014, p.10-11.*

[30] *Wilson, K.E.; ‘Financing High-Growth Firms: The Role of Angel Investors’, December 22, 2011.*

[31] *Wilson, K.E.; ‘Financing High-Growth Firms: The Role of Angel Investors’, December 22, 2011.*

[32] *Sohl, J. and Rosenberg, W.; ‘The US Angel and Venture Capital Market: Recent Trends and Developments’, Journal of Private Equity, 2003 , Vol. 6, No. 2, p. 19.*

[33] *Sohl, J. and Rosenberg, W.; ‘The US Angel and Venture Capital Market: Recent Trends and Developments’, Journal of Private Equity, 2003 , Vol. 6, No. 2, p. 19.*

their portfolio companies.[34] Because of the diversity in expertise and entrepreneurial experience of angel groups, the chances are much better that valuable advice and other industry-specific help can be provided to portfolio companies in case they are facing difficulties . Angel groups can bundle their expertise and knowledge and are therefore better able to guide their portfolio companies through the rough first years of their existence.

Finally, another beneficial consequence of investing in groups is that angel groups on average tend make better investments than most unilaterally operating business angels (however, there are a lot of successful business angels that do a pretty good job investing on their own, in particular "super-angels").[35] This could be explained by the fact that investing in concert with others seems to make business angels more sophisticated investors: they seem to have a stronger rigor during the due diligence process, make use more professional documents and have the opportunity to share workload amongst each other.[36]

As a brief overview of this first chapter, the table on the next page (see figure IV) tries to highlight the characteristics of traditional business angels and venture capitalists. It should be stated however, that business angels often invest using multiple investment strategies at the same time (individually and through syndicates or groups). Additionally, business angels do not only invest in the seed stage of highgrowth start-ups, but also invest in more mature companies and other investment vehicles.[37] Evidence shows that business angels are staying in for follow-on investment rounds more often and are collaborating with venture capitalists (on a personal or fund basis) on an increasing scale.[38] It is therefore fair to say that it is nowadays almost impossible to draw a clear line between business angels and venture capital investors.

[34] Ibrahim, D.M.; 'Financing the Next Silicon Valley', Washington University Law Review, 2010, Vol. 87 p. 744.

[35] Wilson, K.E.; 'Financing High-Growth Firms: The Role of Angel Investors', December 22, 2011.

[36] Wilson, K.E.; 'Financing High-Growth Firms: The Role of Angel Investors', December 22, 2011.

[37] Wilson, K.E.; 'Financing High-Growth Firms: The Role of Angel Investors', December 22, 2011.

[38] Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.12.

Figure IV

Differentiating the key characteristics of angel and VC investors

Characteristics	Angel investors	Venture capitalists
Background	Former entrepreneurs	Finance, consulting, some from industry
Investment approach	Investing own money	Managing a fund and/or investing other people's money
Investment stage	Seed and early stage	Range of seed, early stage and later stage but increasingly later stage
Investment instruments	Common shares (often due regulatory restrictions though)	Preferred shares
Deal flow	Through social networks and/or angel groups/networks.	Through social networks as well as proactive outreach
Due diligence	Conducted by angel investors based on their own experience.	Conducted by staff in VC firm sometimes with the assistance of outside firms (law firms, etc.).
Geographic proximity of investments	Most investments are local (within a few hours' drive).	Invest nationally and increasingly internationally with local partners
Post investment role	Active, hands-on	Board seat, strategic
Return on investment and motivations for investment	Important but not the main reason for angel investing	Critical. The VC fund must provide decent returns to existing investors to enable them to raise a new fund (and therefore stay in business)

Chapter II: The Venture Capital Exit

When successful portfolio companies have matured, venture capitalists typically try to exit their positions by taking the company public through an initial public offering (hereafter "IPO") or by selling their stake to other parties (trade sales, secondary sales and buy-backs).[39] By exiting their investment in the aforementioned ways, venture capitalists are able to distribute the proceeds to investors, raise new funds, and invest in a next generation of highgrowth companies. However, 'traditional' exit markets hamper, and successful exits with high returns (especially IPO's) have become more difficult to pursue. Despite the fact exit markets have shown some recovery in the last years (as is reflected by the fact that the fifteen most capital efficient venture capital-backed tech exits of 2013 saw an aggregate valuation of $18.57 billion on total funding of just $471.5 million[40]), the 'golden days' of the period before the burst of the dotcom-bubble seem to be something of a distant past.

In order to provide a short overview of the traditional venture capital exit, the two most important exit strategies, the IPO and the Trade Sale, will be briefly discussed hereafter.

2.1. The Initial Public Offering (IPO)

The dream of a glorious IPO is still widely considered to be one of the main drivers for innovative entrepreneurs to find their own companies.[41] IPO's have for years been the most successful exit strategy for venture capital backed start-up companies around the world; the IPO used to be the 'golden standard' for venture capital success.[42] Hundreds of IPO's of venture capital backed start-ups, with up to forty times return on investment for investors, took place during the late 90's in the United States alone.[43]

IPO's offer the public the opportunity to buy stock of a particular company on a stock exchange like the NASDAQ, the NYSE, the Tokyo Stock Exchange, the London Stock Exchange or the AEX, while on the other hand providing early investors with an ideal exit strategy. Through an IPO, venture capitalists usually manage to make the most profit from liquidating their successful investment.

Besides being the most lucrative venture capital exit, an IPO provides founders and key-employees with crucial entrepreneurship-encouraging incentives as well.

[39] *National Venture Capital Association, 'Yearbook 2014', March 2014, p.71.*

[40] *'The Most Capital Efficient Venture Capital-Backed Tech Exits of 2013', CB Insights, December 12, 2013.*

[41] *McCahery, J.A. and Vermeulen, E.P.M.; 'Venture Capital, IPOs and Corporate Innovation', July 25, 2013.*

[42] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 102.*

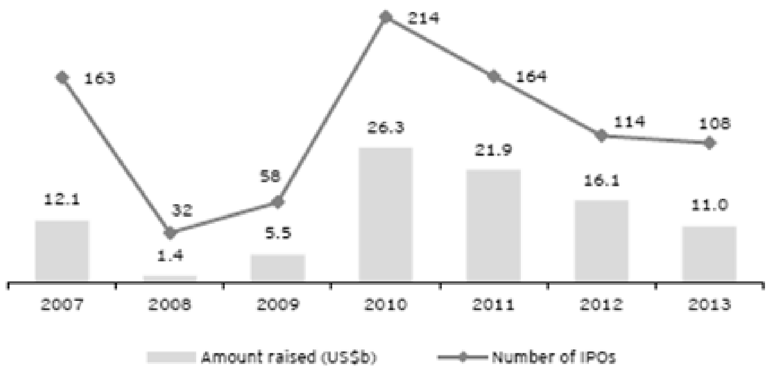
[43] *Metrick, A.; 'Venture Capital and the Finance of Innovation', John Wiley & Sons, Inc., 2007.*

First, by offering them the opportunity to sell (part of) their shares to the public, a successful IPO enables founders and key-employees to receive a significant return on all the money and time they have spent on the company. Second, an IPO enables them to regain control over the firm's affairs after the venture capital investors have sold their converted preferred shares to the public.[44] In this way, founders and key-employees can recapture the power over a company in which they have invested part of their lives.

Unfortunately, the hampering IPO-markets have not only changed the venture capital cycle, but have weakened the aforementioned entrepreneurship-encouraging incentives as well. Since the burst of the dot-com bubble numbers of successful IPO have dropped dramatically and the time period between a company´s seed-stage and an IPO has increased significantly: from 3 to 6 years in the period from 2000 to 2004 up to 6 to 9 years in the period from 2008 to 2013.[45] These troubled prospects of a successful IPO (a decreased likelihood and an extended exit horizon) have the potential to discourage entrepreneurship: entrepreneurs are nowadays less secure of, and have to wait longer for the financial gains offered by an IPO. Of course, founders and key-employees will normally be able to co-sell their stake in a lucrative trade sale as well (see next paragraph), but this exit normally offers neither the allure nor the exceptional returns of an IPO.

Figure V

Global Venture Capital Backed IPO's 2007-2013



To make things worse, a smaller change of a successful IPO implies that founders and key-employees have less prospects of regaining control over the company after the venture capital investors have disposed of their positions on the public markets. This can potentially have the same entrepreneurship-discouraging effect, because people will be less inclined to dedicate a significant amount of effort to a company over which they will never be able to exercise control anymore.

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[44] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.*

[45] *National Venture Capital Association, 'Yearbook 2014', March 2014, p.72.*

However, there is some good news: with 81 venture capital backed IPO's, 2013 has been the best 'IPO-year' since 2007 in the United States. [46] And although in 2013 the global number of, and amount raised from venture capital-backed IPO's decreased (see figure V), a strong last quarter and many older venture capital portfolio companies ready to go public provide indications of a more positive environment for IPO's in the coming years.[47] More importantly, some indications of recovery could be found in IPO-markets in the United States (number of venture capital-backed IPO's rose nearly 50%), China (a 523% rise in the median amount raised prior to an IPO and a 77% increase in the median pre-IPO valuation of venture capital backed companies) and Europe (three-fold increase in the median pre-IPO valuations of venture capital-backed companies).[48]

Another reason to be conservatively optimistic about the recovery of the IPO-markets is provided by the emergence of regulatory initiatives around the world that attempt to relax rules and regulations for companies that want to list their shares on a stock exchange. Consider the American JOBS Act for example. This act provides some regulatory relief for firms that wish to pursue an IPO by allowing them to qualify as an 'emerging growth company' (EGC). This status offers some benefits to highgrowth companies in the pre- and post-IPO period, such as so-called 'testing the waters provisions' (that allow an EGC to verify professional investors' interest in buying its shares prior to or immediately after the date of the IPO registration statement) and the opportunity to confidentially present a draft IPO registration statement for evaluation by the American Securities and Exchange Commission (SEC).[49] Furthermore, the EGC status excludes companies from certain obligations regarding auditor control, executive compensation and accounting standards. To see the success of the JOBS Act, consider the fact that almost two-thirds of the companies that conducted an IPO in the United States in 2013 made use of the its confidential filing provision, including multibillion dollar-valued social media giant Twitter.[50] Similar efforts to lower the entry-barriers for firms pursuing an IPO can already be found in Israel (the Tel Aviv Stock Exchange (TASE) reduced burdens for 'R&D firms' considering an IPO) and are seriously considered by other stock exchanges around the world.[51]

Nevertheless, despite these signs of slowly recovering (and changing) IPO markets, the fact remains that an IPO as exit strategy has become generally unavailable to the majority of companies. And that has a significant impact on the venture capital cycle, as will be thoroughly explained in chapter III.

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[46] *National Venture Capital Association, 'Yearbook 2014', March 2014, p.73.*

[47] *Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.4.*

[48] *Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.5.*

[49] *Dittmer, J., McCahery, J.A. and Vermeulen, E.p.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[50] *Data derived from Renaissance Capital. See www.renaissancecapital.com.*

[51] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.*

2.2. The Trade Sale

Although it is widely accepted that venture capitalists and entrepreneurs traditionally have a strong preference for IPO's as exit event, a second way for venture capitalists to exit their position in a portfolio company has become the most important exit strategy: the trade sale.[52] A trade sale basically means that the company - in which the venture capitalist has invested – is being acquired by (or merged with) another company. In this way, the venture capitalist normally receives a return on investment by selling its stake to the acquiring company. Due to the still sluggishly performing IPO-markets, trade sales have become the most important exit for venture capitalists around the globe, with a total of 636 venture capital-backed M&A deals at a median deal value of $398,3 million in 2013.[53]

Since IPO's have become elusive for a majority of venture capital-backed firms, trade sales have not only become the dominant but also the preferred exit strategy for venture capitalists.[54]

In comparison with IPO's, trade sales offer some significant benefits. First, trade sales provide investors and founders/key-employees with immediate liquidity without onerous lock-up periods that prohibit them to sell their stock immediately in case of an IPO. Second, expensive and complicated disclosure obligations and requirements for venture capitalist firms to retain a number of board seats, are no issue in case of a trade sale.[55]As a consequence of the increasing popularity of trade sales, venture capitalists have started to prepare most of their portfolio companies for an acquisition by a strategic corporate investor.[56] By pursuing this strategy, venture capitalists increase their portfolio companies' prospects of a successful exit and attract more interest from institutional investors.

Finally, this initial focus on trade sales as preferred exit strategy does not only augment portfolio companies' chances of a successful exit, but leads to them being ready for an exit event significantly sooner than in the event of an IPO as well (in the United States for example, IPO's currently have a median exit horizon of 6,8 years in comparison with a 5-year exit horizon for trade sales).[57]

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[52] Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.

[53] Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.4.

[54] Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.

[55] Haislip, A.; 'Essentials of Venture Capital, Hoboken'; John Wiley & Sons, Inc., 2011.

[56] Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.

[57] Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.6.

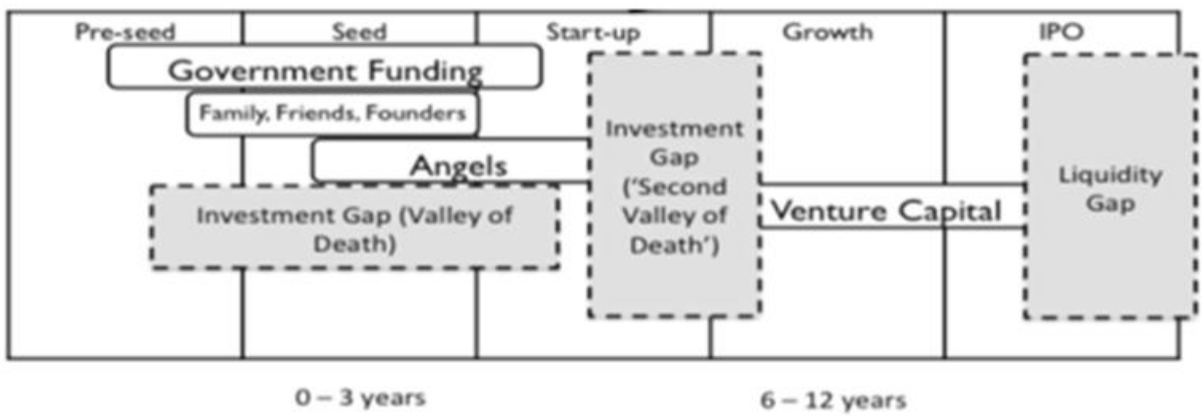
Chapter III: New Developments in the Venture Capital Industry

3.1. The New Venture Capital Cycle

It is clear that the financial crisis of 2008 has aggravated the conditions of venture capital markets worldwide.[58] However, the underperformance of the IPO-markets and the subsequent delivery of uninspiring returns by venture capitalists has started already after the burst of the dot-com bubble in 2000/01.[59] Nevertheless, despite these harsh conditions the venture capital cycle is not broken. It is rather fair to say that profound changes in the venture capital industry, in particular with regard to the timing of IPO's and trade sales, have led to a 'new venture capital cycle'.[60]

When defining ways in which the recent developments have changed the traditional venture capital cycle, two main trends can be observed. First, for most highgrowth companies IPO's have become a generally unavailable exit strategy.[61] This development has moved venture capitalists to the financing of less risky, later stage companies.[62] As a consequence of the expended time period between incorporation and venture capitalists' first involvement, more start-ups are left short of liquidity in the early stages of their lifecycle. This 'investment gap' (or the 'Second Valley of Death', see figure VI) has caused new types of investors, such as large corporations, online crowdfunding platforms and so-called 'super-angels', to come in and provide the necessary financing.[63]

Figure VI



[58] *Block, J. and Sandner, P.; 'What is the effect of the current Financial crisis on venture capital financing? Empirical evidence from US internet start-ups', MPRA Paper No. 14727, April 2009.*

[59] *'A Kink in Venture Capital's Gold Chain', THE NEW YORK TIMES, October 7, 2006.*

[60] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.*

[61] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[62] *'Web Start-Ups Get Upper Hand Over Investors, VC Firms Drive Up Valuations, Attach Fewer Strings to Deals', WALL STREET JOURNAL, March 10, 2011.*

[63] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

Second, a prolonged exit horizon for investors in highgrowth start-ups (i.e. venture capitalists, corporations, (super-)angels, founders and key employees) has caused a so-called ‘liquidity gap’ in the cycle (see figure VI). This liquidity gap makes it more difficult to align the different interests of the aforementioned investors, who normally pursue different exit strategies.[64] As a consequence of this longer exit horizon, alternative liquidity providers, which can potentially provide the venture capital industry with the necessary liquidity to keep on operating smoothly, have emerged. One of these alternative liquidity providers is the so-called “secondary market”.

The impact of the ‘new venture capital cycle’ on the term sheet will be discussed later on in this paper. First, the most notable developments in the world of venture capital will be considered briefly.

3.2. New Investors

3.2.1. Super-Angels

According to data from the European Venture Capital Association, over the past few years so-called ‘super-angels’ have turned into a significant force in venture capital markets in Europe and the United States.[65] Super-angels are basically funds managed by former successful entrepreneurs that contribute a significant amount of their ‘own’ money.[66] Usually super-angels carry out a “spray and pray” investment strategy: they make a lot of small investments in the seed or early stages of start-ups, with first round-investments typically ranging from $100.000 to $1 million. [67] However, their involvement can in some cases lead to investments with a value of over $5 million.

In recent years, the rapid growth in the number of super-angel funds has created an investment segment between traditional business angels and venture capitalists.[68] Like venture capitalists, super-angel funds employ full time managers and take management fees and a share of the profits. By using their strong personal networks, super-angels are often capable of attracting entrepreneurs as easily as venture capitalists.[69] In addition to that, due to their strong connection to their former line of business, “super-angels” are often better able to pick out the ‘winners’ at the seed or early stages, than venture capitalists.[70]

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[64] *Mendoza, J.M. and Vermeulen, E.P.M.; ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity’, May 3, 2011.*

[65] *European Venture Capital Association; ‘2013 European Private Equity Activity: Statistics on Fundraising, Investments and Divestments’, 2013.*

[66] *Mendoza, J.M. and Vermeulen, E.P.M.; ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity’, May 3, 2011.*

[67] *‘Internet start-ups, Another Bubble?’, THE ECONOMIST, 18 December 2010.*

[68] *Sahlman, W. and Richardson, E.;’ The Changing Face of Angel Investing’, November 16, 2010.*

[69] *Litan, R. and Schramm, C.; ‘Better Capitalism: Renewing the Entrepreneurial Strength of the American Economy’, Yale University Press, September 2012.*

[70] *Mendoza, J.M. and Vermeulen, E.P.M.; ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity’, May 3, 2011.*

Additionally, super-angels are very well able to mentor their portfolio companies through the very early start-up period as a consequence of them having a lot of business experience themselves. This will increase the chances for the portfolio companies to secure follow on financing from traditional venture capitalists or corporate venture funds.[71] Finally, like the angel groups and syndicates that have been discussed before, super-angels are better suited to fill the 'second investment gap' of start-up companies than individual business angels. Moreover, their business experience and strong connection with the business world enables super-angels to drastically increase the prospects of success of their portfolio companies.

While the term "super-angels" has been commonly used in the United States for the last decade or so, it is only recently becoming more popular in Europe and other countries.

However, there is still some discussion about whether there really exists something as super-angels or whether super-angels are basically micro venture capitalists since they are also investing money from other people instead of only their own. Anyway, when taking into account the size of some successful 'super-angel-funds', such as Atomico (raised a $165 million dollar-fund in 2010) and Ambient Sound Investments (around $100 million), one could easily argue that nowadays super-angels are professional money managers rather than traditional 'angel' investors.[72]

3.2.2. Crowdfunding

As a consequence of the fact that venture capitalists are investing more conservatively these days, new types of investors have stepped in to fill the funding gap in the earlier stages of the life cycle of start-up companies.[73] Crowdfunding is one example of a 'new' way for entrepreneurs to secure ´venture capital´ from a big group of people, without the typical drawbacks of ´traditional´ venture capital such as tough negotiations over contractual terms and time-consuming and costly due diligence periods.[74]

Individuals making an investment through crowdfunding platforms, so-called 'crowdfunders', usually receive a return on their investment in case the company matures and prospers. Due to the fact that the relatively small amounts invested by 'crowdfunders' through crowdfunding platforms and/or social networks (such as Twitter, Facebook and LinkedIn), do not justify tight investor involvement,

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[71] *Dittmer, J., McCahery, J.A. and Vermeulen, E.p.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[72] *Wilson, K.E.; 'Financing High-Growth Firms: The Role of Angel Investors', December 22, 2011.*

[73] *Dittmer, J., McCahery, J.A. and Vermeulen, E.p.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[74] *Dittmer, J., McCahery, J.A. and Vermeulen, E.p.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

contracts that govern the investment do not have to be as exhaustive as traditional venture capital term sheets.[75]

Especially platforms that offer equity-based crowdfunding (meaning that each 'investor' will become the direct (or indirect) beneficial owners or shareholders of that particular company) are playing an increasingly important role in funding innovative start-ups. [76] And despite the fact that crowdfunding has some serious drawbacks for entrepreneurs, such as the lack of value-added services and a flimsy connection with potential follow-on investors, its popularity is growing at an astonishing pace. The global market for crowdfunding has expanded from less than $1 billion dollar in 2010 to more than $5 billion last year and successful crowdfunding platforms are emerging on a global scale.[77] Popular platforms such as Crowdfunder (US), Crowdcude (UK), FundingDream (China) and Crowdbank (Japan) are attracting thousands of 'investors' and entrepreneurs and hundreds of millions of financing.

Consider the incredible story of the Pebble Technology Corporation. This technology start-up tried to secure $100.000 of financing on crowdfunding-website Kickstarter in order to develop a 'smartwatch' that could be connected to mobile phones and other electronic devices. What happened afterwards provides a good example of the remarkable power of 'the crowds'. This seemingly cozy idea of the Pebble Technology Corporation, that was called 'the Pebble', managed to attract an astonishing $10.3 million of financing (of which over $1 million was obtained within the first 28 hours) provided by more than 70.000 online backers.[78]

However, as appealing as these success stories may sound, crowdfunding is not always an appropriate way of securing financing for innovative entrepreneurs. First, unlike business angels and venture capitalists, crowdfunding 'investors' do normally not closely monitor and support the company after their investment.[79] Consequently, these 'investors' do usually not help the company with things like identifying and evaluating business opportunities, attracting additional capital and providing management assistance.[80] The absence of these value added services has the potential to distort the company's growth. Second, crowdfunded businesses lack the connection to follow-on investors in most occasions. This problem is caused by the fact that crowdfunding investors make smaller

[75] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[76] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[77] *'Crowdfunding Gains Ground in Japan', WALL STREET JOURNAL, June 27, 2014.*

[78] *'The Top 25 Crowdfunding Success Stories', AlleyWatch, March 14, 2013.*

[79] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[80] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

investments and have less incentives (and resources) to support portfolio companies in obtaining the next round of financing.[81]

These two 'deficiencies' of crowdfunding arguably make this way of securing financing less attractive for entrepreneurs in capital-intensive industries that are less appealing to the public, such as biotechnology and healthcare. However, some recent developments may drastically change this perception. Consider AngelList. AngelList, which basically holds the middle between crowdfunding and 'super-angel' investment, is an increasingly used online platform that matches start-up companies with investors in the United States.[82] Besides offering start-ups the opportunity to quickly find and negotiate early stage financing, AngelList enables investors to 'follow' companies and monitor growth and developments.[83] Moreover, because of the fact that people 'investing' through AngelList are not financing start-ups directly but are rather backing experienced entrepreneurs that make investments and help their portfolio companies with expertise and business knowledge, the traditional crowdfunding-problem of lacking value-added services is significantly mitigated as well.

Finally, due to its soaring popularity among venture capitalists and other institutional investors as well, start-up companies have also been able to secure follow on finance using AngelList's platform.[84]

In summary, crowdfunding is a new way of financing highgrowth start-up companies that has to be considered seriously. Online platforms like AngelList offer start-ups the benefits of obtaining 'venture capital' while sidestepping complicated due diligence procedures and time-consuming contractual negotiations. In addition to that, AngelList offers investors the opportunity to monitor their investment and enables entrepreneurs to obtain value-added services and follow on rounds of finance. It may be less of a surprise that similar initiatives are emerging in Europe (Dealroom) and other countries around the world.[85] It is therefore fair to say that crowdfunding, besides providing funding to awesome ideas such as the Pebble, has the potential to become a serious alternative for the 'traditional' funding of start-up companies as well.[86]

[81] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[82] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[83] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[84] *'Naval Ravikant, AngelList: A Social Network That Connects Startups With Investors', THE HUFFINGTON POST, September 20, 2011.*

[85] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[86] *'Crowdfunding Industry Report', CrowdSourcing.org, May 2012.*

3.2.3. Corporate Venture Capital and Collaborative Partnerships

After the burst of the Internet bubble in 2000/01, corporate involvement in the venture capital industry declined significantly. However, corporations have, in the aftermath of the financial crisis of 2007-2008 , regained market share by increasing their investment and involvement in innovative technology companies. [87] Nowadays, corporate funds such as Google Ventures, Intel Capital and Samsung Ventures are among the most active venture capitalists in business and the fact that the largest European venture capital fund to be raised in the first half of 2013 was Unilever's €350 million Venture II Fund, is symbolic for the increasingly prominent role of corporate venture capital.[88]

Nevertheless, despite the fact that some corporate venture capital funds managed to deal with the post-2008 economical downfall way better than traditional venture capitalists[89], there are some reasons that justify skepticism towards corporate venture capital. First, corporate venture capital divisions have often unclear objectives and lack the expertise and experience to succeed in the world of venture capital. Additionally, corporate venture capital divisions usually have difficulties establishing an effective governance and compensation system within the bigger corporate environment, potentially leading to badly monitored and managed investments. Equally important, corporate venture capital divisions usually find it hard to penetrate traditional venture capital networks that are highly based on interpersonal relationships and mutual trust. As a consequence, identifying the best investment opportunities often poses more challenges to them.[90] Finally, managing minority interests in portfolio companies can cause accounting as well as antitrust problems for the corporation itself.

On the other hand, entrepreneurs are often afraid that obtaining venture capital from a corporation will restrict future exit opportunities and brings about risks of 'negative signaling' in case the corporate venture capital fund decides not to provide future follow on investment rounds.[91] More importantly, securing capital from corporate venture capital investors could potentially lead to competition and confidentiality issues in case the particular corporation is involved in the same line of business or technology as the start-up. Corporations could abuse due diligence and information rights to obtain sensitive information and could mistreat their control rights to frustrate the development of competitive technologies.

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[87] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[88] *'European venture capital fundraising makes gains on Q1 2013', Private Equity Wire, July 29, 2013.*

[89] *Lerner, J.; 'How Corporate Venture Capital Helps Firms Explore New Territory', Harvard Business Review, September 10, 2013.*

[90] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[91] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

All these factors make that both corporations and entrepreneurs should seriously question themselves if involvement in corporate venture capital actually benefits their business. However, new models of corporate venture capital have begun to emerge and venture capital investors have recently started to establish partnerships with mature corporations on an increasing scale.[92] These partnerships, characterized as 'collaborative corporate venture capital models', consist basically a collaboration between venture capitalists and corporations and offer some significant benefits to the parties that allow them to significantly mitigate the aforementioned problems of traditional corporate venture capital. On the one hand, corporations are able to profit from expertise and experience brought in by the venture capitalist' managers, whereas on the other hand venture capitalists benefit from an corporate investor that plays an active role. By being involved, the corporation can help the venture capitalist to select the right portfolio companies and provide precious support in order to make the portfolio companies grow and prosper. Additionally, involvement of large corporations with deep pockets implies that venture capitalists have to be less concerned about securing funds from other limited partners.

At least as important is the fact that the corporation can provide the venture capitalist with a possibility to exit. In case it has interest in obtaining the portfolio company's technology, for example, the corporation can acquire the company, thereby granting the venture capitalist the opportunity to exit its position and get some return on investment. With the current sluggishly performance of the IPO-markets, this potential exit offers a great advantage to venture capitalists. Moreover, a venture capitalist that cooperates with multinationals has excellent opportunities to invest in the multination's spin-off or spin-out companies. On the other hand, entering into a collaborative corporate venture capital partnership with a traditional venture capitalist has some important benefits for corporations as well. Corporations will be better introduced in the world trust- and relation-based world of venture capital and can benefit from the experience and expertise of venture capitalists in selecting and nurturing innovative start-ups with the strongest growth potential.[93] In this way, corporations are being offered a brighter 'window to the market' that can help them spot new developments in an earlier stage.

The impact of the increasing activities of Corporate Venture Capital funds and the rising popularity of Collaborative Corporate Venture Capital partnerships on the term sheet will be discussed later on in this paper.

[92] *Derived from www.globalcorporateventuring.com.*

[93] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

3.2.4. Governmental Venture Capital and Collaborative Funding Models

After the financial crisis and the subsequent economic downfall, governments have started to realize their crucial position in funding and facilitating entrepreneurship and innovation.[94] Governments around the world, aware of new opportunities being offered by the financial crisis, have tried to relax entry barriers for start-up companies and have provided entrepreneurship-enhancing tax incentives. In addition to that, direct public funding for innovative start-ups has been provided on an increasing scale.[95]

Direct funding by governments is not a new phenomenon, and many innovative start-up companies in the United States obtained finance from public programs such as the SBIR (Small Business Innovation Research) program.[96] It may be a little known fact that even the success of a company like Google can be partially attributed to government funding: the algorithm that led to Google's early success was funded by a public sector National Science Foundation grant.[97]

Despite the aforementioned, government funding has started to gain momentum after the financial crisis. Over the last couple of years, according to the global accountant firm Ernst&Young, public aid and government funding have become the second-most important source of funding (after bank credit) for innovative entrepreneurs.[98] Moreover, governmental funding programs are also considered as one of the most preferential sources of help for entrepreneurs. By improving a company's access to debt and other financing, governmental funding can act as a powerful catalyst for innovative start-ups, and companies that are (partially) government-funded seem to outperform companies who have only received funding from private venture capitalists.[99]

However, public interventions do not always have their aimed-for effect. As is shown by research, most government initiatives are poorly designed and lack understanding of 'entrepreneurial ecosystems'.[100] As a result, lots of efforts by governments smother in cumbersome, bureaucratic and inefficient practices.

A solution to this problem of overly bureaucratic and inefficient government initiatives is being provided by a new breed of public venture capital funds: the so-called collaborative funding models.

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[94] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[95] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[96] *Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.14.*

[97] *Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.14.*

[98] *Ersnt&Young, ' G20 Entrepreneurship Barometer 2013'.*

[99] *Brander, J., Du, Q. and Hellman, T.; 'The Effects of Government-sponsored Venture Capital: International Evidence', National Bureau of Economic Research, November 2010.*

[100] *Hwang, V. and Horowitt, G.; 'The Rainforest: the Secret to Building the next Silicon Valley', Regenwald, 2012.*

These funds basically operate like ‘public-private partnerships’ in which capital contributed by governments is pooled with funding from private investors.[101]

As a consequence of the fact that these ‘public-private partnerships’ are managed private sector fund managers, these funds are more connected to the venture capital industry and therefore are better able to pick ‘winners’.[102] It is therefore fair to say that the private managers and investors play a crucial role in these government programs. The government itself is essentially merely acting as a strategic investor, thereby trying to achieve its objective of developing a sustainable venture capital ecosystem that is better able to spur innovation and entrepreneurship.

Over the last years, collaborative funding models have emerged around the globe. In Australia, the Pre-Seed Fund, the Renewable Energy Equity Fund and the Innovation Investment Follow-on Fund provide excellent examples of ‘public-private partnerships’ that were successful in encouraging entrepreneurship and innovation, while equally successful initiatives can be found in countries like Israel (the Yozma program) and Germany (the High-Tech Gründerfonds).[103]

It follows from the aforementioned examples that properly structured ‘public-private partnerships’ are a strong tool for governments to develop a robust venture capital industry, and that collaborative funding models will play an increasingly important role in the world of venture capital in the coming years.

3.2.5. Incubators and Accelerators

Another development in the world of venture capital that is worth noticing is the increasing presence of accelerator and incubator programs. The fact that venture capitalists are more reluctant to invest in seed- and early-stage start-up companies and the fact that capital efficiencies have significantly brought down the cost of starting a company, have fueled a boom in new accelerators and incubators around the globe.[104]

Incubators and accelerators are basically programs that provide guidance and support to seed-stage enterprises in order to help them develop an innovative idea into an actual business. An accelerator provides small amounts of capital and some form of mentorship in return for parts of equity in externally developed ideas. Accelerators generally consist a program with a limited period of time (three or four months) after which the involved start-ups ‘graduate’. [105] The accelerator phenomenon is

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[101] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; ‘The ‘New’ Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms’, November 20, 2013.*

[102] *Dittmer, J., McCahery, J.A. and Vermeulen, E.P.M.; ‘The ‘New’ Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms’, November 20, 2013.*

[103] *Cumming, D., Dai, N. and Johan, A.; ‘Hedge Fund Structure, Regulation and Performance around the World’, Oxford University Press, 2013.*

[104] *‘Tech Startups Benefit from Accelerator Boom’, WALL STREET JOURNAL, June 4, 2014.*

[105] *‘Accelerator vs. Incubator: What’s the Difference?’, Inc.com, February 7, 2014.*

growing worldwide, especially in the United States, and prominent accelerators are receiving an increasing amount of attention from entrepreneurs. Consider the popular accelerator program Y Combinator. Y Combinator makes innovative entrepreneurs come to Silicon Valley for a three-month 'bootcamp' during which it intensively supports the entrepreneurs in making their business idea interesting for investors. After this period, Y Combinator organizes a meeting with potential investors during which entrepreneurs can pitch their ideas and try to attract financing.[106] The success of Y Combinator's 'new' approach is proven by the fact that renowned companies like Dropbox (online file-sharing platform) and Airbnb (rental website for holiday-rooms and -apartments), with multibillion dollar valuations, are among its 'graduates'.

Incubators, on the other hand, bring in external management to manage ideas that were developed internally.[107] In comparison with accelerators, incubator involvement normally takes much more effort and time and therefore incubators take a larger amount of equity from the start-ups they support. Highly successful incubators like California based Idealab usually come up with innovative business ideas themselves, after which they recruit people from outside to bring these ideas to fruition.[108]

Although incubators are not a new phenomenon, they are globally becoming more recognized as a capital source and are currently commanding larger pools of capital than ever before.[109]Additionally, the increasing involvement of governments in incubator-programs over the last couple of years is remarkable. An excellent example of a government-sponsored incubator is being provided by a program called Start-Up Chile. This government initiative tries to lure entrepreneurs to Chile by offering them small amounts of capital, local support and working visas.[110] Start-Up Chile claims to have already backed more than 1,000 fledging firms, among which success stories such as online cruise-booking service CruiseWise and taxi-booking platform SaferTaxi.com.[111]

[106] *See www.ycombinator.com.*

[107] *'Accelerator vs. Incubator: What's the Difference?', Inc.com, February 7, 2014.*

[108] *See www.idealab.com.*

[109] *Ernst&Young, 'Adapting and Evolving: Global Venture Capital Insights and Trends 2014', January 2014, p.11.*

[110] *´Start-up Chile: Growing Pains of the Chilecon Valley', THE HUFFINGTON POST, July 2013.*

[111] *'The Lure of Chilecon Valley', THE ECONOMIST, October 13, 2012.*

3.3. A New Venture Capital Exit: the Secondary Market

Despite the aforementioned types of 'new' investors that fill the 'second investment gap' in the venture capital cycle, such as crowdfunding platforms and super-angels, the problem of the so-called 'liquidity gap' remains. As discussed before, the sluggishly performing exit markets and the prolonged exit horizon have caused some serious liquidity problems for the venture capital industry. As a consequence, the venture capitalist industry's profits are under increasing pressure and institutional and other investors are investing fewer money.

However, there is some good news. As will be thoroughly discussed in the following section, the rising global popularity of secondary market venues can potentially offer a solution to the problem of reduced liquidity in the venture capital cycle.

3.3.1. The Secondary Market: Definition

Over the past two decades, an increasing number of market venues specifically designed to ease exits by venture capitalists have been created by governments and regulators around the world.[112] These market venues are called 'secondary markets'. Secondary market venues can be found all over the world: renowned venues such as SharesPost and SecondMarket (United States), KOSDAQ (South Korea), JASDAQ (Japan), NPEX (Netherlands) and IlliquidX (United Kingdom) are only the 'tip of the iceberg'.

In short, the secondary market is the market place where investors in private companies - individual investors as well as venture capitalists – can sell their shares in a particular company well before that company conducts an IPO or is being acquired as part of a trade sale. [113] In other words: a (well-functioning) secondary market provides investors with liquidity: they can exit or reduce their positions at their preferred moment in time by selling shares to other parties on the secondary market. This increased liquidity is the paramount advantage of secondary markets.

A second important beneficial characteristic of well-functioning secondary markets is the fact that they can function as an important tool for investors to govern the start-up companies they have invested in.[114] Consequently, in the presence of well-functioning secondary markets, agency costs on the side of both entrepreneurs and investors can be decreased significantly.

A third advantage of well-functioning secondary markets is that such markets avoids rash exits that can hurt the start-up companies. Due to the fact that the venture capitalist that is in need of capital can exit its investment by selling its stake on the secondary market, there is less pressure on the start-up to

[112] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.*

[113] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)'. Vanderbilt Law Review, Vol. 65, 2012; p. 116.*

[114] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 116.*

rush to an IPO or trade sale.[115] As a consequence, start-up companies that are backed by venture capital have more time to properly mature, which leads to more efficient outcomes because these companies will not be forced into a premature exit in order to satisfy the liquidity needs of its investors.[116] Moreover, the aforementioned benefits will drastically mitigate the conflicts over traditional exit strategies between entrepreneurs and investors.

3.3.2. The Secondary Market: Benefits and Drawbacks

The aforementioned beneficial characteristics of secondary market trading can potentially have a very positive impact on venture capital markets, from which both venture capitalists and entrepreneurs can benefit.

The first and most important advantage is that secondary market trading increases the liquidity in the venture capital market when traditional exit markets hamper (as has been the case over the last years). Venture capitalists can now more easily exit or reduce their positions whenever they are in need of capital, for example in case a venture capital fund's lifetime is about to expire and venture capitalists must return capital to their investors. Additionally, due to the fact that information about companies and their investors is now better available and potential buyers and sellers of stock in private companies better know where to find each other, venture capitalists are able to locate parties that might be interested in buying their stake more easily, and therefore are generally better able to do business with interested buyers.

On the other hand, entrepreneurs benefit from increased market liquidity as well. They enjoy the same improved opportunities to sell their stake as investors do, and additionally profit from the fact that liquid markets attract more investors and investments, and consequently increase their prospects of securing financing from venture capital funds or other investors.[117]

Another advantage of increased liquidity offered by secondary markets is that agency cost-increasing situations, like capital- and investor-lock-ins, are avoided. In the case of sluggishly performing traditional exit markets, capital- and investor-lock-ins can pose a real threat due to the fact that they significantly increase agency costs and the cost of capital.[118] By offering investors the opportunity to exit their investments when they prefer to, lock-in situations are avoided.

The second advantage of secondary markets is the improved governance of venture capital investments. Due to allocated control rights, agency costs in high-growth start-up investments are generally high. When entrepreneurs are in control of the company, the venture capitalist can suffer

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[115] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.*

[116] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 103.*

[117] *Ibrahim,D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 124.*

[118] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 113.*

from opportunistic behavior by these entrepreneurs (this is called entrepreneurial opportunism).[119] Entrepreneurs may abuse their control to extract private benefits, like high salaries, at the expense of the venture capitalist.[120] As the start-up grows and the venture capitalist is contributing additional capital, the control situation can change. As a consequence of providing additional capital, the venture capital will receive more shares and board seats, and at a certain point control will shift from entrepreneur to venture capitalist. This process can lead to the opposite problem: high agency costs for entrepreneurs because of the fact that they are now vulnerable to opportunistic behavior by the venture capitalist.[121]

In general it does not make a great difference if the entrepreneur or the venture capitalist is in control of the company: agency costs will occur. And although it seems impossible to reduce these agency costs completely, a well-functioning secondary market can play an important role in mitigating them.

Before the introduction of the secondary direct market, governments tried to lower agency costs by imposing fiduciary duties on the parties involved. However, as a consequence of the fact that venture capital investment differs significantly from other forms of capital investment and shareholding, these fiduciary duties appeared to be far from effective in most cases. First, due to venture capitalists normally only investing in preferred shares that typically only have contractual rights, venture capitalists are neither protected by, nor subject of the fiduciary duties that apply in relation with common shareholders. This means that in case venture capitalists fail to protect themselves sufficiently in their investment contracts against all unforeseen forms of opportunistic behavior by entrepreneurs, they just have bad luck.[122] Second, fiduciary duties are neither efficient in the reverse situation of controlling venture capitalists acting opportunistically. Finally, other constraints to mitigate opportunistic behavior in start-ups, such as independent directors and shareholder voting, have neither proven to be flawless so far. [123]

It is therefore fair to say that, in order to improve the governance of venture capital-backed start-ups, the secondary markets present a welcome alternative to flawed legal rules and regulations. In short, we can say that a well-functioning secondary market is better able to reduce agency costs than ineffective legal rules. But how does the secondary market benefit entrepreneurs as well as venture capitalists? Firstly, like said before, a well-functioning secondary market makes both the shares of the entrepreneur as well as the shares of the venture capitalist more liquid. They now both can threat to

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[119] *McCahery, J.A. and Vermeulen, E.P.M.; 'Limited Partnership Reform in the United Kingdom: A competitive, Venture Capital Oriented Business Form', February 9, 2005.*

[120] *Fried, J.M. and Ganor, M.; ' Agency Costs of Venture Capitalists Control in Startups', New York University Law Reiew, 2006.*

[121] *Fried, J.M. and Ganor, M.; ' Agency Costs of Venture Capitalists Control in Startups', New York University Law Review, 2006.*

[122] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 129.*

[123] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 129.*

abandon the company in case they are unsatisfied with its performance. The entrepreneur(s) and the venture capitalist(s) are aware of the fact that they need each other in order to make the start-up a success story, and that a premature exit of the other can negatively influence the company's development. As a consequence, an important incentive for the parties involved to perform at their best is provided.[124]

A second benefit with regard to the governance of start-up companies, is the fact that the increased liquidity significantly diminishes the vulnerability of the parties to opportunistic behavior. Both entrepreneurs and venture capitalists now can easily exit by selling their shares on the secondary market in case the other (controlling) party is behaving opportunistically and this behavior is hurting their interests. Another advantage of this easy exit opportunity is the fact that costly and time-consuming litigation about issues like shareholder expropriation and fiduciary duties can now be avoided more often.[125] Unsatisfied shareholders can sell their stake on the secondary market instead of wasting money and time in complicated litigation procedures.

The fact that conflict situations between entrepreneurs and venture capitalists about traditional exits are avoided or mitigated is a third beneficial consequence of secondary market trading. As said before, in a situation without a secondary market venture capitalists tend to put pressure on entrepreneurs to conduct a traditional exit, like an IPO or trade sale. An IPO does normally not cause a lot of problems in this context because IPO's generally generate high returns for both investors and entrepreneurs, while on the other hand allowing entrepreneurs the opportunity to regain control over the company.[126] Trade sales, however, are normally more problematic. In case the company is being acquired, the venture capitalist will receive a return on his investment, but the entrepreneur will normally not have the chance to recover control. The acquirer will from now on be in control and due to the fact that venture capitalists normally have a high liquidation preferences, it can occur that other shareholders will not even receive a return on their investment in case the amount of money paid by the acquirer is not very high.[127] As a consequence, premature exit events like trade sales can be very disadvantageous for entrepreneurs and other common shareholders. Despite all this, boards controlled by venture capitalists may prematurely push for such a traditional exit well before the company has reached its full potential, thereby hurting the interests of common shareholders and the company itself.[128] In case a well-functioning secondary market exists, venture capitalists can easily exit by selling their

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[124] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 129.*

[125] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 130.*

[126] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 130.*

[127] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 132.*

[128] *Fried, J.M. and Ganor, M.; ' Agency Costs of Venture Capitalists Control in Startups', 81 New York University Law Review, 2006, p. 129.*

positions. Consequently, the possibly damaging pressure on start-ups to rush to a traditional exit is less of a concern and investors can focus more on long-term value creation. [129] This will lead to companies better reaching their full potential and eventually higher overall shareholder value.
In summary, well-functioning secondary markets benefit both entrepreneurs and investors by offering increased liquidity, by improving start-up governance and by mitigating conflicts between entrepreneurs and venture capitalists about rash exits.

However, despite their beneficial characteristics secondary markets can potentially have two important drawbacks. First, improved secondary trading can potentially reduce incentives for entrepreneurs and investors to maximize their performance. [130] In the situation one can exit whenever he wants to, the incentive to closely monitor the company, perform at their best and to provide value-added services can be diminished for investors. The same goes for entrepreneurs. As opposed, in a situation where exiting is much more difficult, incentives to maximize success are greater because it is difficult for both entrepreneurs and investors to abandon the company. Second, a company of which the shares are being traded on a secondary marketplace bears the risk that one of its competitors acquires its shares and subsequently tries to obtain sensitive information about the company's operations and activities by exercising the information rights attached to these shares.
Although these are serious concerns, in practice they are mitigated as a consequence of several circumstances. First, most of the entrepreneurs (and employees) that sell their stake in the secondary market are no longer working at the company.
Second, as a consequence of Share Transfer Restrictions, Vesting Schedules, tightened Board Approvals and other contractual provisions, entrepreneurs and employees that still work at the company usually face a lot of restrictions to sell their stake (these restrictions and provisions, normally included in the venture capital term sheet, will be thoroughly discussed in chapter V). The same goes for venture capitalists: besides the aforementioned contractual restrictions that can apply to them as well, venture capitalists are usually weary to sell their whole stake to a random investor due to reputational constraints. Instead, they try to seek high-caliber replacements that bring complementary value-added services to the table, in order to further support the growth of the start-up company and to enhance their own reputation as an entrepreneur's best way to success.[131]
Conclusively, the emergence of secondary markets has brought significant benefits for venture capital investors as well as for entrepreneurs. Secondary markets increase liquidity, improve governance and alleviate conflicts between entrepreneurs and venture capitalists. And despite the fact that secondary market trading in the shares of private companies has some obvious drawbacks and is still surrounded

[129] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 132.*

[130] *Ibrahim, D.M.; 'The New Exit in Venture Capital (2010)', Vanderbilt Law Review, Vol. 65, 2012; p. 134.*

[131] *D.M. Ibrahim, 'The New Exit in Venture Capital (2010). Vanderbilt Law Review, Vol. 65, 2012;; p. 134.*

by regulatory fog in most jurisdictions, secondary markets have the potential to provide an excellent solution for the problems caused by the liquidity gap in the venture capital cycle.

Chapter IV: The Term Sheet

In the first three chapters of this paper, the main characteristics of venture capital and angel investing have been discussed. In addition to that, current trends and developments in venture capital markets worldwide have been briefly analyzed. This fourth chapter will focus on the most important legal document of business angel and venture capital investing: the Term Sheet. First, commonly used provisions and clauses of the term sheet will be discussed. After that, in chapter V, an overview will be provided of the impact of recent developments, like the emergence of online crowdfunding platforms, secondary markets and corporate venture capital, on the term sheet as such.

4.1. The Term Sheet: Definition

After entrepreneurs have managed to find an investor (business angel, angel group, venture capitalist, etc.) that believes in their idea or business, and is willing to invest, the parties have to define and agree upon the exact terms of investment. The terms of investment are outlined in a legal document that is called the term sheet. This legal document has two main functions: 1) to summarize and outline the significant legal and financial terms that are related to the investment and 2) to quantify the value of the transaction both in qualified terms and numbers.[132]

The term sheet, used by both business angels and venture capitalists, is considered to be the most important legal document that governs the agreement between entrepreneur(s) and investor(s). It establishes the framework for all important agreements between the parties and as a consequence has a more than significant impact on the start-up company and its prospects for success. The investor(s) normally draft the term sheet and present it to the company, after which it can be subject to (heavy) negotiations by the parties.

In order to avoid excessive, overly time-consuming negotiations in the early stages of a potential investment, the parties try to agree upon a relatively short term sheet. In the term sheet, the parties seek to highlight several key issues that require specific attention and try to make a mutual 'moral commitment' to use the agreed-upon terms in the term sheet as 'guidance' in future negotiations.[133] Essentially, the term sheet makes the parties focus on the essence of crucial terms and clauses in their agreement, prior to initiating expensive and time-consuming legal drafting and the insertion of boilerplate clauses.[134] In this way the term sheet speeds up negotiations between entrepreneurs and

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[132] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 7.*

[133] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p.7.*

[134] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p.7.*

investors, and enables highgrowth start-ups to save time in securing finance. Time that is crucial in today's world of fierce competition and swift innovation.

Due to the fact that almost every entrepreneur, start-up company and investor differs to a certain extent, almost all investment terms and agreements differ. All parties have different preferences, different bargaining power and do business in different jurisdictions and legal climates. Therefore, it is fair to say that there does not exist one basic template of a term sheet that can be used in all deals. It is the context of the investment that plays a crucial role on the content of the term sheet.[135] To what extent do the parties have bargaining power? One could think of an example in which an entrepreneur has invented something that can potentially become the next Google or Apple. His invention will attract a lot of attention from investors and therefore he can choose with which investor he wants to do business. As a consequence, the bargaining power of this entrepreneur will rise significantly, and he will be able to negotiate for more entrepreneur-favorable deal terms.

Another factor that can have a great influence on the content of the term sheet, is the jurisdiction in which the entrepreneur tries to obtain financing. For example, an entrepreneur in Silicon Valley can try to obtain funding from numerous business angels and venture capitalists, while an entrepreneur in the Netherlands has by far not as many possibilities to obtain financing. In addition to this, the United States venture capital environment is primarily built on trust and reputation, while these factors are far less developed in other countries around the world.[136] The existence of these trust-based relationships among venture capitalists improves the attractiveness and effectiveness of the venture capital market in the United States. As a consequence, term sheets in countries outside of the United States usually contain more investor favourable compensation agreements.[137]

With the exception of legally binding provisions that deal with issues such as confidentiality, exclusivity and legal- and drafting fees, the provisions of the term sheet do technically not legally bind the parties.[138] The term sheet creates an implied duty for the parties to negotiate in good faith and the term sheet reflects an agreement between the parties to proceed according to the terms agreed-upon in the term sheet.[139] This means that the parties, after signing the term sheet, cannot always freely walk away or unilaterally try to modify the terms of the term sheet without an appropriate reason. Especially in some European jurisdictions, parties are legally obliged to act in good faith when

[135] *The British Business Angels Association and Evershedds LLP; 'Improving The Investment Process: The Standard Legal Documents And How to Use Them', 2008, p.12.*

[136] *Armour, J. and Cumming, D.; 'The Legal Road to Replicating Silicon Valley', 27 November 2003.*

[137] *Armour, J. and Cumming, D.; 'The Legal Road to Replicating Silicon Valley', 27 November 2003.*

[138] *The British Business Angels Association and Evershedds LLP, 'Improving The Investment Process: The Standard Legal Documents And How to Use Them', 2008, p.12.*

[139] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 9-10.*

deciding not to continue the investment according to (some of) the terms set out in the signed term sheet.[140]

In essence, by signing the term sheet the parties morally commit themselves to keep the agreed-upon terms in the term sheet as 'guidance' in future negotiations.[141] In this way, the terms sheet provides a framework that makes future negotiations less complicated and disputed.

4.2. The Term Sheet: Provisions of the Term Sheet

This paper will now shed some light on provisions that are commonly used in term sheets, and as a consequence of the fact that the venture capital industry in the United States and Europe is this paper's focal point, term sheet provisions commonly utilized in these jurisdictions will consist the main focus of this section.

4.2.1. The Preamble

The term sheet's preamble normally contains a period stating the time the term sheet will be in place. The preamble may also contain provisions that limit the entrepreneur's ability to search for other investors (see '*exclusivity*' later on). In addition to that, parties can agree on so-called 'lock-up provisions', meaning that it is forbidden for any person within the company to discuss the content of the term sheet with third parties without having obtained the prior (written) consent of the investor.[142]

4.2.2. Opening Information

A short summary of the proposed deal is normally given this section. The Opening Information is providing a brief overview of the deal and clarifies the nature of the transaction and the parties. However, nowadays it is more common that the title of the term sheet states the parties involved and therefore the section Opening Information is being left out of the term sheet more often.[143]

4.2.3. Offered Terms

According to its name it may be no surprise that this section contains the terms that are offered by the investor. The Offered Terms provide information about (among others) the amount of capital invested, the number and type of shares issued, the pre- and post-money valuation and the transaction' closing date. The different terms that make up the section 'Offered Terms' will now be analyzed briefly.

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[140] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p.22.*

[141] *The British Business Angels Association and Evershedds LLP; 'Improving The Investment Process: The Standard Legal Documents And How to Use Them', 2008, p.12.*

[142] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 32.*

[143] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 32.*

4.2.4. Amount, Issuer, Investor, Number of Shares & Closing Date

The Offered Terms normally start by stating the 'issuer' of the shares – which is the company that is being invested in – and the 'investor' – which obviously is the entity that is making the investment. After that, the 'amount invested' contains the total amount of capital that is being invested in this transaction, while the total amount of shares issued and the number of shares that will be received by the investor will be specified as well. Finally, the closing date states the day at which the deal will be closed, and normally terms offered in the term sheet can be accepted by the 'issuer' until this closing date.

4.2.5. Type of Security

This part of the term sheet requires the highest level of attention from the parties involved. It is crucial for both entrepreneurs and investors to have a thorough understanding of the impact that the issuance of different types of securities can have on the future of the company. First, investors can subscribe to common class of shares; this type of shares normally grants the investor one vote per share and no additional rights at all.[144] Common shares are in most cases issued when the entrepreneurs themselves, or their friends and family, invest in the company.

Besides common shares, investors can choose to invest in convertible debt. Convertible debt, which is commonly used by business angels, is basically a bridge loan that converts into equity during the next investment 'round' and enables investors to determine the company's value in the next investment round.[145]

As a third option, investors can ask for preferred shares. Preferred shares give investors substantially more rights when compared with the aforementioned common shares. Venture capitalists require these preferred rights due to the fact that they normally invest much more money than the company's founders, while they are less involved in the company's daily business and therefore have less control.[146] Preferred shares can grant their owners 'preferred' rights such as multiple voting rights per share, preferred dividends, the opportunity to appoint board members, certain veto-rights, etc.[147] In this way, venture capitalists have more opportunity to actually influence the company's decision-making and performance, and better opportunities to control and monitor their investment.

In the situation that a certain class of preferred shares already exists at the time of a venture capital investment round, new series of preferred shares will usually be effected in order to distinguish the

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[144] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 32.*

[145] *MIT Entrepreneurship Center, 'Venture Support Systems Project: Angel Investors'(2000), MIT Entrepreneurship, p. 38.*

[146] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 13.*

[147] *Fried, J.M. and Ganor, M.; ' Agency Costs of Venture Capitalists Control in Startups', New York University Law Review, 2006, p. 129.*

rights (voting, liquidation preference, conversion, etc.) attached to this series of preferred shares from the rights that are enjoyed by holders of prior preferred series.[148] In the world of venture capital it is common practice that different series of preferred shares enjoy different rights, because the financings made at the time of the creation of each series are made under different circumstances, with different company valuations and risk predictions.[149]

As a consequence of the fact that venture capital investors usually invest in a preferred class of shares, only term sheet provisions that are used with regard to a preferred shares-investment will be considered below.

4.2.6. Price per Share, Company Valuation, Milestones and Warrants

The price per share and the company valuation are other crucial components of the term sheet. The price per share is determined based on the pre-money valuation of the company, which is the actual value of the company, before the investment as proposed by the term sheet, is made. The company's post-money value is determined by adding the value of the investment to the pre-money valuation. The price per share is the purchase price per share that is paid by the investor, and is normally calculated by dividing the company's pre-money valuation by the total number of fully diluted shares (i.e. all shares issued, shares allocated to the option pool and any other shares that the company could be obliged to issue through warrants, options or other obligations) issued prior to the execution of the investment transaction.[150]

With regard to the aforementioned, there are three more terms that have to be considered: the Option Pool, the Warrants and the so-called Milestones. If the company wants to grow and prosper, it needs to be able to attract the most talented employees and it needs to align the interest of these employees with those of the company. In order to achieve this, companies usually make use of a Employee Share Option Plan. By granting (key) employees options from a so-called Option Pool, the company provides them with an extra incentive to perform at their best: if the company does well and conducts and IPO or is being acquired, the employees will be able to benefit as well by selling their options. The Employee Share Option Plan and the Option Pool will be thoroughly discussed later on in this chapter.

Warrants, on the other hand, provide investors with an extra incentive to stimulate the growth of the company and to provide additional financing in the future. Although warrants usually only apply to situations in which the company has already raised a round of equity, they are sometimes used in early

[148] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 8.*

[149] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 8.*

[150] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 8.*

stage investment agreements as well.[151] In case the company issues warrants, it grants the acquirers of these warrants the right to purchase securities within a certain timeframe for a pre-defined price. This can be very beneficial for investors, because warrants give investors additional upside in the event that the company conducts a IPO or is being acquired for a price higher than pre-determined warrant price. Finally, an often used way to incentivize the company itself to perform at its best is the usage of Milestones. It is pretty common that investors decide to not make their entire investment on completion. Instead they invest the money in different tranches that are subject to several targets being met by the company. Failure to meet these targets, which are often called Milestones, does not automatically imply that the investor is released from the obligation to provide the additional money, but may imply that the investor is allowed to negotiate for different, more investor-favorable terms for these amounts.[152]

4.2.7. Dividend Rights

Dividend rights allow investors to get some return on their investment without them having to sell their shares. Dividends are essentially a distribution of the company's profits (in cash or stock) to its shareholders.[153] The dividend paid per share depends on the profits made by the company and the type of shares that are being held by the investor. In case of preferred shares, the dividend paid normally consists of a fixed percentage of the shares´ purchase price. In addition to that, preferred shareholders typically receive dividends in preference of the holders of common stock at a predefined moment in time (in most case dividends will be paid out once a year). However, there are some exceptions. Most early-stage companies prefer to reinvest all the profits directly into growing their business, and therefore decide to refrain from paying out dividends (remarkably, even matured companies such as Google and Amazon do not pay their shareholders any dividends).[154]

Most dividends are non-cumulative. This means that in case the company's directors do not declare dividends during a particular fiscal year, the shareholders' right to be given dividend extinguishes for that year.[155] However, a small percentage of financings (less than 10 percent) makes use of cumulative dividends.[156] With cumulative dividends, shareholders' right to receive a fixed dividend is carried forward until it is paid out by the company (or the right is terminated). This basically means that for every period that dividends accrue, any dividend not disbursed cumulates until the company is in

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[151] *Feld, B. and Mendelson, J.; 'Venture Deals: Be Smarter than your Lawyer and Venture Capitalist', John Wiley & Sons, Inc, 2011.*

[152] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 9.*

[153] *'Demystifying the VC Term Sheet: Dividends', VentureBeat, February 28, 2011.*

[154] *'The Biggest Companies That Don't Pay Dividends -- But May Be About To', YAHOO FINANCE, June 14, 2013.*

[155] *'Demystifying the VC Term Sheet: Dividends', VentureBeat, February 28, 2011.*

[156] *'Demystifying the VC Term Sheet: Dividends', VentureBeat, February 28, 2011.*

possession of the necessary capital. Although not very common, investors sometimes require for cumulative dividends in order to provide themselves with a minimum annual rate of return on their investment.[157] On the other hand, cumulative dividend rights can be used by the company to ensure that is it not obliged to pay out dividends while it is growing.

Finally, in addition to the aforementioned dividend preference, holders of preferred shares often demand for dividends to be paid out on a pro-rata basis, meaning that preferred shareholders are entitled to participate in any distributions on the common shares.[158] By doing so, preferred shareholders avoid the situation that the company declares a relatively small amount of dividend to the preferred shareholders, followed by the declaration of a much larger amount of dividend to be paid out to holders of common shares.

4.2.8. Liquidation Preference

The liquidation preference, arguably one of the most important provisions of the term sheet, is a right that is typically required by investors to compensate them for the risks they bear on their contributed capital.[159] Although a great variety of liquidation preferences exists, these provisions normally provide that preferred shareholders receive a certain amount of the company's proceeds before any other shareholder, in case of a liquidation event. Investors usually demand that their liquidation preference is not only applicable in the event of a liquidation of winding up of the company, but also in the event of a merger, acquisition, consolidation or change of control of the company. (in some cases a liquidation preference is even deemed applicable in case of an IPO or a qualified exit).[160]

The amount of the proceeds received by the holders of preferred shares may be equal to – or a multiple – of their investment. The company's proceeds that remain are then typically divided amongst the preferred and common shareholders.[161] This distribution can be conducted with the preferred shareholders fully participating (i.e. the proceeds that remained are divided amongst all shareholders on a pro-rata basis) or with the preferred shareholders merely participating (i.e. the common shareholders are compensated for their shares after which the remaining proceeds are being paid to all shareholders out on a pro-rata basis). In case of a Fully Participating Liquidation Preference, parties often put a 'cap' on the maximum amount of proceeds that can be received by investors. This is being done to avoid the situation in which investors benefit disproportionately from their Fully Participating Liquidation Preference by receiving first their liquidation preference and afterwards benefit unlimited from the pro-rata division of the company's remaining proceeds.

[157] *'Demystifying the VC Term Sheet: Dividends', VentureBeat, February 28, 2011.*

[158] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 10.*

[159] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 10.*

[160] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 10.*

[161] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 11.*

In order to reflect the importance of the liquidation preference and the amount of risk involved in each venture capital financing, the liquidation preference provisions will be heavily negotiated and can vary greatly. Factors like the company's valuation typically also play an important role in determining the size and composition of the liquidation preference.[162]

4.2.9. Conversion and Automatic Conversion

Conversion provisions allow preferred shareholders to convert their preferred shares into common shares at any time. The ratio at which preferred shares can be converted into common shares is normally 1:1.[163] The rationale behind this provision is that in case of a liquidation event that is expected to generate a 'common-share-return' higher than the preferred return that derives from the liquidation preference provision (such as an IPO or trade sale with a very high company valuation), preferred shareholders can optimally benefit from this upscale event as well.[164] Another reason for converting their shares into common shares, can be a situation in which a shareholder vote for a specific issue can only be casted by holders of common shares, and therefore preferred shareholders convert their shares in order to be eligible to vote. Normally, the conversion from preferred shares into common shares is irreversible.

In addition to a 'normal' conversion provision, investors often ask for an automatic conversion provision that automatically converts all different share classes into common shares immediately prior to an IPO.[165] As a consequence of the fact that investors only want this automatic conversion to occur where an IPO is expected to generate at least a minimum amount of gross proceeds and sufficient liquidity, the automatic conversion provision normally contains certain negotiated thresholds that have to be met for the automatic conversion to be triggered.[166] By inserting thresholds, like a minimum valuation or a minimum amount of gross proceeds, the preferred shareholders avoid the situation in which their preferred shares are automatically converted when the company is offering its shares at a low value on an insignificant exchange.

4.2.10. Voting Rights

Preferred shares normally come with some form of control rights. The most obvious control right is the shareholder's right to cast a vote in case of a shareholder vote. Normally, holders of preferred

[162] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 11.*

[163] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 12.*

[164] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 47.*

[165] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 12.*

[166] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 13.*

shares and holders of common shares have equivalent voting rights.[167] However, preferred shares that have multiple voting rights, or no voting rights at all, can be found as well. In order for holders of preferred shares to maintain some form of control over the company, other rights that supplement voting rights are typically attached to preferred shares. These control rights will be briefly discussed in the section 'protective division' hereafter.

4.2.11. Protective Provisions

Venture capital investors typically demand for a so-called 'investor majority', meaning that the company cannot take certain decisions without having obtained consent from the holders of a majority (or other determined percentage) of their specific type of shares.[168] Usually, an investor majority is required with regard to decisions that relate to major changes in the company, such as the issuance of new shares, modifications of shareholder rights, mergers and acquisitions, disposal of major assets, significant changes in the company's capital structure, liquidation or winding up, significant debt incurrence, declaration of dividends, alteration in the board's composition, a reorganization and any other decision that can drastically affect the preferred shareholders' position.[169] These consent rights, that aim to protect investors from opportunistic behavior by the company that can have a negative impact on the value of their investment, are restricted by company laws in some jurisdictions. Especially in Europe it can sometimes occurs that local company laws prohibit certain actions of the company's board of directors to be subject to investor consent-rights. In such cases, investors can demand the inclusion of a special board majority clause in the company's articles of association that requires consent of an appropriate quantity of directors appointed by the investors.[170] In this way investors are guaranteed to be able to exercise a certain level of control over some of the board's actions.

4.2.12. Anti-dilution Provision and Pre-emption Rights

In order to safeguard the value of their investment in the best possible way, venture capital investors typically demand the inclusion of a certain degree of anti-dilution protection in the term sheet. Anti-dilution provisions protect initial investors against the risk of dilution in case of a new investment round with a pre-money valuation lower than the post-money valuation of the round at which these investors invested in the first place (this is called a 'down round').[171] Although size and structure can vary greatly, anti-dilution provisions typically make use of complex formulas to calculate the total

[167] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 56.*

[168] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 17.*

[169] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 18.*

[170] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 18.*

[171] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 13.*

number of shares that will be obtained by the holders of preferred shares, at a marginal price or completely for free, in the event of a down round. In this way, the anti-dilution provision (partially) compensates for the effect of the issuance of new shares at a lower price in the down round.

Anti-dilution provisions are inserted in almost every term sheet, however, their nature can differ significantly. Basically, the most common degrees of anti-dilution protection are full ratchet and weighted average protection. Full ratchet provisions, that completely offset the effect of dilution by maintaining investors' ownership at the same level or value, are considered very investor-favorable and therefore are included in only a marginal percentage of term sheets. The other, more commonly used type of anti-dilution protection is the so-called weighted average provision. This provision does not entirely counterbalances the effect of the down round: initial investors will receive some new shares as compensation for the dilution, but their percentage of ownership and/or the value of their stake will decline.[172] The type and level of protection that is included in the term sheet is depending on an array of factors, such as the perceived value of the company at the time of the investment, the probability of future financing requirements and the level of bargaining power of both investors and entrepreneurs.

Another, less favorable way for investors to protect their ownership percentage is provided by so-called pre-emptive rights that are often included in term sheets. Pre-emptive rights allow investors to participate up to the amount of its pro-rata holding, in case the company issues new shares in the future.[173] Although most European jurisdictions automatically provide pre-emptive rights to investors (that can be waived), this is not always the case in the United States and other countries around the world. It is therefore important that investors in these jurisdictions demand the inclusion of pre-emptive rights in the term sheet.

4.2.13. Redemption

Redemption rights provide the company's founders and management with incentives to grow the company and generate liquidity instead of merely running the business in order to pay themselves a salary.[174] Due to the fact that they provide investors a way to rapidly dispose of their shareholding, redemption rights are sometimes demanded by investors to dissuade management from breaching certain agreements.

Redemption rights, although not allowed in all jurisdictions, basically oblige the company to redeem the investors' interest at a fixed price in case certain pre-determined milestones have not been achieved within a certain period of time. One could think of situation in which investors can demand the company to buy back their shares when the company has not been able to conduct an exit event

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[172] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 13.*

[173] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 14.*

[174] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 44.*

(i.e. IPO, trade sale, etc.). A failure of the company to buy back shares when requested may result in additional rights for investors, such as increased voting rights or a magnified right of consent.[175]

4.2.14. Board Composition

Another provision that enables shareholders to exercise some form of control over the company is the board composition provision. This provisions grants investors the opportunity to actively influence the composition of the board of directors. Board composition provisions are of particular interest for investors that spend a higher amount of money on the company (i.e. angels groups and venture capitalists), while in most cases small investors like traditional business angels are less interested in being involved in board matters (business angels will typically take a board seat themselves or will merely provide the company with advice about board issues).

Boards of directors can be structured in two ways: two-tiered and one-tiered. A two-tiered board is made up of a separate management board (executive directors) and supervisory board (non-executive directors), whereas a one-tier board consists both executive and non-executive directors.[176]

By (directly) appointing one or more board members themselves, or at least significantly influencing the appointment of board members, investors are better able to protect their investment by stimulating investor-favorable board decisions.[177] However, by appointing board members investors do not only want to safeguard their own investment, they also try to find directors that can add experience (i.e. some form of business experience that can be useful for the company), thereby benefitting both the company and its investors.

To guarantee a majority vote, boards of directors typically consist of an odd number of directors. Typically, one or more directors will be ‘independent’, meaning that they are neither the company’s founders or key-employees nor persons that are (closely) affiliated with the investors.[178]

In order to secure its objectivity, transparency and accountability, most boards will be guarded by a committee that decides on the boards remuneration an compensation (including share option grants) and an auditing committee overseeing the company’s financial statements and reports. Finally, in most jurisdiction it is required by law that all directors act in the company’s best interest rather than act as a representative of the funds they manage.[179]

[175] *The British Venture Capital Association, ‘A Guide To Venture Capital Term Sheets’, p. 12.*

[176] *The British Venture Capital Association, ‘A Guide To Venture Capital Term Sheets’, p. 18.*

[177] *The British Business Angels Association and Evershedds LLP, ‘Improving The Investment Process: The Standard Legal Documents And How to Use Them (2008) p. 14.*

[178] *Fried, J.M. and Ganor, M.; ‘ Agency Costs of Venture Capitalists Control in Startups’, New York University Law Review, 2006, p.121.*

[179] *The British Venture Capital Association, ‘A Guide To Venture Capital Term Sheets’, p. 18.*

4.2.15. Information Rights and Inspection Rights

The information rights provision gives investors access to crucial information about the company they have invested in. This right to be informed can consist the investor's right to receive the company's audited quarterly or annual financial statements, or, in some cases, the investor's right to have access to all (unaudited) financial statements and other important documents regarding the company. Additionally, information rights can go as far as providing investors unlimited access to the company's books and records.[180] By having information rights, investors are much better able to monitor their investment. The extent of the information rights inserted in the term sheet will depend on the entrepreneur's track record, the inherent risk of the investment and the magnitude of the investor's other control rights.

Despite the aforementioned, however, in some (mostly European) jurisdictions a company is obliged to treat all shareholders equally, meaning that all information provided to one shareholders will have to be divided to all shareholders.[181] This has to be taken into account when drafting the terms and conditions of the information rights in the term sheet.

4.2.16. Registration Rights

Registration rights basically require the registration of the company's securities with the Securities and Exchange Commission (SEC) before the company can offer its shares to the public in the United States. Although the concept of registration rights is alien to most European investors and companies, these rights have to be considered seriously in case the company pursues a future listing on a US stock exchange.[182] Whereas in most European jurisdictions all the company's outstanding shares become tradable upon a public listing, US laws prescribe that the company's unregistered shares will be subject to very burdensome trading restrictions.[183] The value of these unregistered shares will decrease significantly and as a consequence the worth of investors' shareholding may decline as well. Therefore, investors in US companies or companies that might pursue a US-listing in the future usually demand the inclusion of a Registration Rights Agreement in the term sheet. By doing so, investors obtain rights to have their shares registered along with any other shares of the company and investors can demand the company to bear the costs and potential liabilities in relation with the registration process.[184] In addition to that, the registration rights agreement normally stipulate the

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[180] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 62.*

[181] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 19.*

[182] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 20.*

[183] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 20.*

[184] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 20.*

extent to which the holders of preferred shares will continue to enjoy a preferred treatment after their shares are converted into common stock in order after an IPO.[185]

And although all this might seem like a concern of the future, the fact this registration can be a costly, time-consuming and complicated operation makes that the parties should seriously consider these circumstances at the time of the investment.

4.2.17. Rights of First Refusal, Co-sale Rights and Tag-along Rights

Rights of first refusal oblige shareholders that wish to sell their stake in the company, to first offer their shares (under the same terms) to other shareholders who have the benefit of the right of first refusal.[186] In this way, the right of first refusal gives investors the opportunity to exercise some control over the intended sale of shares by other shareholders: if the investor wants to increase its ownership it can decide to buy the offered shares, whereas in case the investors is not able or willing to increase its ownership the shares can be offered to other parties.

In the event that a shareholders wants to dispose of shares that are subject of tag along or co-sale rights, other shareholders that benefit from these rights can demand that the potential buyer agrees on buying an equal number of their shares under the same conditions. The obvious drawback of tag along and co-sale rights is that these rights make it more difficult for shareholders to find an interested buyer in case they want to sell their shares. In short, these rights make the shares of the company less liquid, and therefore potentially less valuable. However, these rights offer some important benefits to venture capital investors. Due to the fact that venture capitalists' decisions to fund a particular company is largely based on its confidence in the company's founders and management. Therefore, venture capital investors try to avoid the situation in which these individuals sell their shares and leave the company, while the venture capitalist resides as a shareholder. In order to achieve this, venture capitalists normally demand for rights of first refusal and co-sale/tag along rights in relation with any sale of shares by the company's founders and/or key-employees.[187]

4.2.18. Drag-along Rights

Drag along rights compel all shareholders to sell their shares to a potential buyer in the situation that a certain percentage of shareholders (or of a specific type of shareholders) decide to sell to that buyer.[188] Drag along rights (which are occasionally called bring along rights) are of particular importance in case a potential buyer wants to purchase all of the company's shares in order to avoid having to consider the rights of small shareholders in the future. Sometimes, venture capitalists demand the

[185] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 64.*

[186] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 15.*

[187] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 15.*

[188] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 16.*

inclusion of several exceptions in the drag along rights. These exceptions are aimed at protecting investors in case they cannot reasonably be required to dispose of their shares. Amongst these exceptions are situations in which investors are obliged to give the acquirer representations and warranties concerning the company or covenants, or the event that the investors will not be paid cash or marketable securities as compensation for their shares.[189]

4.2.19. Employee Share Option Plan

In order to attract the best employees, incentivize them to perform optimally and align their interests with those of the company and investors, most venture capital-backed companies make use of a so-called Employee Share Option Plan. This plan, that is normally agreed upon by the parties in the term sheet, reserves a percentage of the company's stock in a so-called option pool. The shares in the option pool will be used for share option grants to current and future employees, thereby optimally incentivizing employees by allowing them to benefit from the financial rewards resulting from the company's success.[190] The option pool allows the company to grant shares to well-performing employees without having to obtain approval from other shareholders each time. Typically, investors will demand an option pool that contains somewhere between 10 and 20% of the company's share capital. However, the size the option pool depends heavily on factors such as the company's employee-base, the prospects of future financing rounds, etc.

That being said, a bigger option pool is normally benefitting investors disproportionately as compared to the founders. As a consequence of the fact that the option pool is in most cases established at a pre-money valuation, the option pool will come directly from the founders' shares and as a result their stake will dilute.[191]

4.2.20. Vesting and Good Leaver/Bad Leaver Provisions

As said before, the experience and competence of founders and key-employees are usually paramount in the decision of venture capital investors to fund a particular company. As a consequence, investors that decide to back a company want to assure that its founders and key-employees remain in place to deliver their business plan.[192] In order to achieve this, venture capital investors try to make the ownership of these people subject to so-called vesting schedules and good leaver/bad leaver restrictions. When founders' and key-employees' shares are subject to good leaver/bad leaver restrictions, it means that they are obliged to offer their shares to the company or other shareholders in case they decide to take off from the company within a pre-determined period of time. However, the

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[189] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 16.*

[190] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 21.*

[191] *'What Happens to the Employee Option Pool after an Acquisition?', AlleyWatch, January 8, 2014.*

[192] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 14.*

price at which they can offer their shares is not always equal to the fair market price (as is the case with the aforementioned right of first refusal), but depends on the conditions of the departure.[193] Only in the situation that the founder/key-employee is deemed to be a good leaver, he or she is allowed to offer his or her shares for fair market price. On the other hand, does the founder/key-employee breach his or her contract of employment or does he or she resign within a certain period of time, the company (or other shareholders) have the right to purchase the shares for a price that can be considerably lower than the fair market price. In this way, good leaver/bad leaver restrictions provide founders/key-employees with strong incentives to stay loyal to the company for at least a certain period of time.

Additionally (or alternatively), venture capital investors often demand the inclusion of so-called vesting schedules in the term sheet in order to provide founders (and employees in some cases) with extra incentives not to abandon the company shortly after the investment. The effect of vesting schedules is that a percentage of founders' shares will be locked-up for a certain period of time and if the founders want to obtain unrestricted ownership over these shares they will have to stay with the company until all their shares are vested.[194] Although a great variety of vesting schedules is used throughout different investments, the most often seen vesting schedules grant founders 25% of their stake up front (i.e. immediately after the investment is made), while the remaining 75% of the shares vest on a monthly basis over 3 or 4 years.[195] For example, in case the shares of a founder are subject to this kind of vesting schedule with a 3-year lifespan, the founder will have to stay with the company for at least 3 years to regain all his or her shares. If the founder decides to leave within this requisite period, after let's say 2 years, he or she will only keep the shares that are vested. In this scenario, the founder will keep only 75% of his or her original shareholding (75% = 25% (the shares that were immediately vested) + 50% (2/3 of the remaining 75% of the shares that were vested during 2 years)). The unvested shares lose their value and are converted into deferred shares or redeemed by the company for a nominal price.[196] Vesting schedules can contain a provision that enables accelerated vesting in the event of death or termination of the founder's employment through no fault of their own.[197]

4.2.21. Intellectual Property, Confidentiality and Management Non-compete Agreements

As a consequence of the fact that nowadays the most valuable assets of most technology start-up companies consist primarily of intellectual property rights, the importance of decent IP-protection

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[193] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 14.*

[194] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 14.*

[195] *'The Best Vesting Schedule', Simeon Someonov Blog, February 2, 2010.*

[196] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 14.*

[197] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 15.*

mechanisms cannot be overestimated. Therefore, investors often require the company to have certain agreements in place with its employees. These agreements may include Confidentiality Agreements (to protect the company's sensitive information) and Employment Agreements (that assure that all intellectual property developed by its employees belongs to the company).[198]

Additionally, investors often demand that the company's founders and directors sign Non-compete Agreements. Like said before, the experience and business knowledge of these people is paramount in investors' decision to invest in a particular company, and the interest of investors would be significantly harmed in case they would leave the company to establish or work for a competitor. By agreeing in the term sheet on the creation of the aforementioned agreements, investors can mitigate the risk of losing valuable know-how to competitors.

4.2.22. Exclusivity, Confidentiality and Conditions Precedent

The exclusivity provision obliges entrepreneurs to refrain from searching for and negotiating with other potential investors.[199] As a consequence of the fact that most investors spend a considerable amount of time and money on due diligence, professional fees and contractual negotiations, they require the entrepreneur to commit himself to the process as well.[200] Usually, a breach of the exclusivity provision means that the entrepreneur has to incur a financial penalty.

As soon as the negotiations between the company and the venture capital investor(s) about a potential investment begin, a confidentiality agreement should be signed. In case this has not been done, a confidentiality provision should be inserted in the term sheet in order to protect all confidential and sensitive information that has to be exchanged between the parties.[201]

Finally, venture capital term sheets normally contain a list of conditions that have to be satisfied before the agreement will be executed. These conditions are called the conditions precedent, and serve as a roadmap to the completion of the transaction as agreed upon in the term sheet.[202] Often used conditions precedent in venture capital financings include (among others) the satisfactory completion of due diligence, the negotiation of definitive legal documents and the obtainment of all necessary approvals by both investor(s) and entrepreneur(s).[203]

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[198] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 20.*

[199] *This provision can also be called 'no-shop provision'.*

[200] *The British Business Angels Association and Evershedds LLP, 'Improving The Investment Process: The Standard Legal Documents And How to Use Them', 2008, p. 14.*

[201] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 21.*

[202] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 70.*

[203] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p. 22.*

4.2.23. Closing Date, Legal Fees, Expiration Date and Governing Law

The final provisions of the term sheet normally contain the closing date, legal fees, expiration date and governing law don't need too much explanation. It may be no surprise that the Closing Date provision determines the exact date at which the deal will be closed. It is worth noticing that parties should insert a closing date in the term sheet that gives them enough time to draft and thoroughly check all legal documents governing the proposed financing, because hastily dealing with these important matters could easily lead to mistakes and trouble in the future.[204]

It is common that all parties bear their legal fees and expenses (lawyers, legal advice, additional fees, etc.) themselves. However, the parties enjoy contractual freedom to decide otherwise. In any case, the exact allocation of the legal costs in relation with the proposed transaction is normally stipulated in the term sheet's Legal Fees provision.

The Expiration Date provision states the exact date at which the terms as offered in the term sheet will expire. If the entrepreneur decides, for whatever reason, not to sign the term sheet before this date, the term sheet will expire. Finally, the parties have the freedom to choose the law that will govern their agreement. The opted for jurisdiction will be stated in the Governing Law provision.

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[204] *Wilmerding, A.; 'Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations', 2003, p. 79.*

Chapter V: Developments of the Term Sheet

5.1. Developments of the Term Sheet: the Emergence of Crowdfunding, 'Super-Angels' and Incubators and Accelerators

5.1.1. The Non-jargony Term Sheet

Many entrepreneurs, that just have been given a term sheet by a venture capitalist, do not completely understand what they are about to sign. Without the expensive involvement of legal advisers and lawyers, term sheets full of jargon and complicated legal terms and definitions are almost impossible to decipher for most entrepreneurs. As a result, many entrepreneurs have signed terms that weren't in their best interest at all.[205] To make things worse, the extensive due diligence procedures that are common practice for venture capitalists, are not only time-consuming and costly for entrepreneurs, but can cause confidentiality issues as well.[206]

Due to the emergence of successful crowd funding platforms such as AngelList (United States), Crowdcube (UK) and FundingDream (China), entrepreneurs around the world have been granted the opportunity to secure 'venture capital' without having to undergo lengthy due diligence procedures and involve themselves in costly and complicated contractual negotiations.[207] These characteristics make crowdfunding a very attractive alternative for (especially) seed-stage start-up companies in search of financing. Additionally, successful accelerators, (government sponsored) incubator s and 'super-angels' provide entrepreneurs with a more easily accessible alternative to obtain finance and value-added services from experienced business people.

In this respect, it is interesting to see a remarkable trend in the world of venture capital contracting: the emergence of the easily accessible, non-jargony and more transparent term sheet. Passion Capital, a London-based firm, is an example of a venture capitalist that is using simple, short term sheets written in plain English.[208]

Passion Capital's term sheets are transparent, accessible (they can be downloaded directly from its website) and can be understood by a 12-year old.[209] As one of Passion Capital's partners, Eileen Burbidge, explains: "It occurred to us that since all VC term sheets are non-binding anyway – and make a pretty big deal stating that – then there shouldn't be any reason for them not to be worded in

[205] *'What a Straight Forward, Non-Jargony Term Sheet from a VC Looks Like', BUSINESS INSIDER, June 20, 2013.*

[206] *Cumming, D. and Johan, S.; 'Venture Capital and Private Equity Contracting: An International Perspective', Elsevier Insights, 2014, p. 306.*

[207] *Dittmer, J., McCahery, J.A. and Vermeulen, E.p.M.; 'The 'New' Venture Capital Cycle and the Role of Governments: The Emergence of Collaborative Funding Models and Platforms', November 20, 2013.*

[208] *'One Year On, Passion Capital Proves Its Mettle As A Go-To Seed VC In Europe', TechCrunch, May 3, 2012.*

[209] *See www.passioncapital.com.*

plain, conversational English. It all just pointed to one extra needless step -- full of formality -- that we were glad to get rid of."[210] In addition to that, Passion Capital's term sheet are – according to them – pretty entrepreneur friendly as well.

Based on their success – Passion Capital has become one of the most active early stage venture capital funds in the world – it is fair to say that Passion Capital's accessible and understandable way of conducting venture capital investment has become increasingly appealing to entrepreneurs. Especially in Europe, where entrepreneurs from the continent *en masse* flock to London looking to secure financing from Passion Capital and other, more 'Valley-style' investors.[211]

However, shorter and better understandable term sheets are not only becoming a common phenomenon in Europe, but in the cradle of venture capital, Silicon Valley, as well. Due to the fact that time becomes more important and investors try to close deals at an increasing pace, term sheets in the Valley are becoming shorter too.[212] "Many venture capital deals are similar in nature and therefore much of the extraneous information can be left out", says Samuel B. Agnus, partner at the renowned Silicon Valley based lawfirm Fenwick & West LLP. "Any term sheet includes stipulations on the size and pricing of the investment, participating investors, liquidation preferences, restrictions on founder stock, basic investor protections, the size of employee option pools and rights of first refusal, and therefore it's no longer necessary to go into a detailed description of these terms at length. "Those things need to be addressed in the term sheet, but even then there's a recognition that we don't need to go into every detail," Angus said. For example, he said, there's no need to negotiate hypothetical terms such as what happens if a company goes public during its Series B funding. "It's irrelevant at that point and unnecessary to negotiate it.".[213]

In conclusion, the increasing presence of online crowdfunding platforms, accelerators, (government sponsored) incubators and 'super-angels' has had a remarkable impact on the term sheet. The fact that venture capitalists are starting to use shorter, more transparent and better understandable term sheets, allows them to negotiate and close deals at an increasing pace. On the other hand, entrepreneurs are much better able to understand the offered terms, saving a lot of time and money spent on legal advice. In today's world, where innovative ideas have come under an ever increasing competitive pressure, the faster and more easily entrepreneurs can secure finance in order to start growing his innovative business, the better. Therefore, this recent evolution of the term sheet should be heralded as a positive development.

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[210] *'What a Straight Forward, Non-Jargony Term Sheet from a VC Looks Like', Business Insider, June 20, 2013.*

[211] *'One Year On, Passion Capital Proves Its Mettle As A Go-To Seed VC In Europe', TechCrunch, May 3, 2012.*

[212] *'In Silicon Valley, Shorter Term Sheets Make for Faster Deals', Fenwick & West LLP, June 5, 2014.*

[213] *'In Silicon Valley, Shorter Term Sheets Make for Faster Deals', Fenwick & West LLP, June 5, 2014.*

5.1.2. The Venture Capital Code of Conduct

It is interesting to see that some of the same principles that fueled the emergence of the non-jargon term sheet, play a key-role in another recent development in venture capital land: the self-imposed Venture Capital Code of Conduct. This code of conduct is an attempt of well-established and reputable venture capitalists such as Gil Dibner[214] of DFJ Esprit (more than $7 billion in capital commitments) and Jason Mendelson[215] of the Foundry Group (early backer of online game giant Zynga), to restore entrepreneurs' confidence and trust in the venture capital ecosystem.

And while it is true that most national venture capital associations already have codes of conduct and standards of behavior in place, the fact that these reputable investors impose tightened ethical standards on themselves is another example of the climate change in the industry.

As said before, recent developments, such as the increasing popularity of online crowdfunding platforms, have allowed entrepreneurs to secure 'venture capital' more easily, thereby surpassing lengthy due diligence procedures and tough negotiations with more experienced venture capitalists. The implication is that entrepreneurs can now save time and avoid being lured into unbeneficial deal terms by more experienced venture capitalists. In order to mitigate these advantageous characteristics of crowdfunding, the proposed codes of conduct specially emphasize that investors will respect the entrepreneur's time and will do no harm to his interests.[216]

In addition to that, reputable venture capital investors have started to notice that the reputation of the industry is being harmed by acts of unscrupulous and unprofessional venture capitalists.[217] Venture capital investors should act decently at all times, according to Gil Dibner. In order to make investors act this way, the proposed code of conduct of both Dibner and Mendelson consists commandments such as "I will be transparent", "I will educate", "I will be honest", "I will avoid surprises" and "I will not collude with other investors to harm your company".

The effort of reputable venture capitalists to restore flaws in the system by coming up with a code of conduct is both remarkable as praiseworthy. And although it has to be said that it remains highly unlikely if the 'scrupulous' investors that do most reputational harm will obey to such commandments, the fact that venture capitalists are trying to impose higher ethical standards upon themselves in order to regain entrepreneur-confidence and to restore confidence in the industry is a development that should be welcomed by all parties involved.

[214] *'Towards a Venture Capital Code of Conduct', VentureBeat, January 17, 2014.*

[215] *Mendelson, J.; 'I'm Adopting a VC Code of Conduct', Mendelson'sMusings, January 22, 2014.*

[216] *'Towards a Venture Capital Code of Conduct', VentureBeat, January 17, 2014.*

[217] *Mendelson, J.; 'I'm Adopting a VC Code of Conduct', Mendelson'sMusings, January 22, 2014.*

5.2. Developments of the Term Sheet: the Secondary Market

As discussed before, the increasing popularity of secondary market venues, such as SharesPost and SecondMarket (United States), KOSDAQ (South Korea), JASDAQ (Japan), NPEX (Netherlands) and IlliquidX (United Kingdom), offers some important benefits to (venture capital) investors around the world. As analyzed in chapter two, secondary markets can increase liquidity, improve governance and alleviate conflicts between entrepreneurs and venture capitalists.

However, secondary markets have two important drawbacks. First, they can potentially create misalignment of incentives between the company, its founders and key-employees in the situation that these last two groups dispose of a relevant part of their shares: it is well-known that a smaller stake in a venture capital-backed company often leads to founders and key-employees dedicating less effort towards the company's future success.[218] Therefore, you could argue that the emergence of secondary markets has demolished an important venture capital interest-aligning-mechanism. Second, a company of which the shares are being traded on a secondary marketplace bears the risk that one of its competitors acquires its shares and subsequently tries to obtain sensitive information about the company's operations and activities by exercising the information rights attached to these shares.

5.2.1. Share-Transfer Restrictions

In mitigating these deficiencies, the venture capital term sheet plays an important role and as a consequence has developed significantly over the last years. First, parties have started to include more share transfer restrictions in the term sheet.[219] In fact, data gathered by the popular US secondary marketplace SharesPost exposes that a large majority of transactions (90%) handled by this marketplace is subject to contractual transfer restrictions.[220] An effective transfer restriction that can be inserted in the term sheet in order to mitigate the risk of competing firms becoming shareholders, is the right of first refusal (see chapter IV). Due to this right, that requires founders and/or key-employees to offer their shares to other shareholders before they can sell to other parties, investors can avoid that competitors become shareholder of the company by purchasing the offered shares themselves. A share transfer restriction that can mitigate the risk of founders and/or key-employees losing their incentives to perform at their best, is the requirement that these persons are only allowed to sell a certain (small) percentage of their shareholding within a certain period of time.

[218] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011. p. 24.*

[219] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011.p. 24.*

[220] *'SecondMarket trading doubles in private company stock', CNN MONEY, 22 January 2011.*

5.2.2. Tag-Along Rights, Co-Sale Rights, Vesting Schedules and Employee Share Option Plans

Second, investors increasingly require tag-along or co-sale rights, board approval provisions, prolonged vesting schedules and employee share option plans to be inserted in the term sheet. In this way, they can better protect themselves against the risk of being stuck as an investor in a company in which the founders and key-employees have no (significant) interest anymore. Tag-along or co-sale rights ensure investors that in the situation that the founders and/or key-employees sell (part of) their shares, they can sell an equal part of their shares as well, while prolonged vesting schedules and employee share option plans make sure that founders and key-employees are 'tight' to the company for a longer period.

5.2.3. Board Approval and Milestones

Third, tightened board approval provisions can mitigate both the risk of competitors becoming a shareholder and misalignment of interests. By making the disposal of shares by founders and key-employees subject to board approval, investors (that have appointed some of the directors) can ensure that these shares will not be sold to the company's competitors. On the other hand, by making the board's approval subject to the achievement of certain milestones by the company, the founders and key-employees will be provided enough incentives to perform: the board will not allow these people to sell their shares in case the milestones are not met.

Finally, it needs to be said that the secondary markets pose some of the same risks for the founders of the company. In case a venture capital investor can easily dispose of his shares, he will be more inclined to provide the company with value-added services and additional financing. Therefore, the measures discussed above are designed to protect the interests of the founders as well. By making it more difficult for them to exit their investment through the secondary market, investors will be more incentivized to do their best in helping the company grow and prosper.

When considering the aforementioned, it may be obvious that the term sheet plays a very important role in protecting the parties against the risks that have arisen with the emergence of secondary markets. However, the downside of all these measures is the fact that they can drastically decrease the liquidity of the company's shares. And increased liquidity was one of the main advantages offered by secondary market venues. Therefore, it is extremely important that the parties, when negotiating the term sheet, try to find the exact balance between mitigating the risks posed by secondary market trading and preserve the liquidity of the company's stock.

5.3. Developments of the Term Sheet: Trade Sales as most popular exit and the emergence of Collaborative Corporate Venture Capital Models

As discussed before, Trade Sales have become the most popular exit strategy for venture capital-backed companies around the world. Not only have their volume and numbers surpassed those of IPO's, Trade Sales have become the preferred exit for most investors as well.

This phenomenon of Trade Sales as wished-for exit strategy is caused by the underperformance of the global IPO-markets and strengthened by the increasing venture capital-related activities of big corporations. In this respect, it is interesting to see that venture capital investors have started to prepare their portfolio companies at an early stage for acquisitions by strategic corporate investors.[221] This development has not solely led to portfolio companies being ready for a Trade Sale earlier, but has changed the content and magnitude of some terms and provisions in venture capital financing agreements (i.e. the term sheet) as well. Additionally, although not a new phenomenon, increased corporate involvement in the world of venture capital has some implications for the Term Sheet as well.

5.3.1. Share Transfer Restrictions, Investor Obligations and Registration Rights

First, as a consequence of the fact that investors are more and more focusing on the company being acquired by a trade buyer or another company in the future, term sheet-provisions that prohibit investors to sell their stock immediately after an IPO, and provisions that oblige them to maintain board seats after the company went public, have become less relevant. Additionally, provisions consisting the parties' agreement regarding formal issues such as Registration Rights have lost significance as well.

5.3.2. Automatic Conversion Rights

Second, in the situation a future trade sale is considered the preferred and most likely exit, parties should think about making the company as attractive as possible for potential corporate buyers when negotiating the term sheet. This can potentially be done by broadening the scope of the Automatic Conversion provisions to include trade sales. Because in some cases it will be very difficult to persuade certain shareholders (especially former disgruntled founders and/or employees) into converting their shares, the Automatic Conversion is necessary to avoid situations in which these shareholders hold-up the transaction. More importantly, Automatic Conversion will help evade that the acquirer is valuing the target company at a lower price as a consequence of it having all different

[221] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011, p. 9.*

sorts of shareholders with various rights.[222] However, venture capital investors will only agree on these measures in case the Automatic Conversion of their preferred shares is subject to certain thresholds. This is to avoid the situation that they are being stripped of their preferential rights in the event of a lousy bid by a potential acquirer. Parties could for example agree on inserting thresholds on the minimum amount of money that has to be offered by the acquirer for the shares in order for the Automatic Conversion to apply.

5.3.3. Redemption Rights, Rights of First Refusal and Call- and Put-Options

Third, it is remarkable to see big corporations actively participate in venture capital industries. Not only have Corporate Venture Capital funds such as Google Ventures, Intel Capital and Samsung Ventures become more dominant in venture capital markets, the emergence of Collaborative Corporate Venture Capital partnerships between big corporations and venture capitalists shows that corporations are taking venture capital more serious than before. Corporate Venture Capitalists and Collaborative Corporate Venture Capital partnerships offer entrepreneurs the benefits of more easily accessible follow-on financing (the corporations involved normally have deep pockets) and the opportunity to profit from the expertise and specific know-how that big corporations have to offer. In addition, the fact that corporate funds normally have a longer lifespan than traditional funds avoids the situation in which investors conduct a forced exit at an inappropriate time.[223] This lower pressure of delivering returns to investors within a certain period makes that Corporate Venture Capitalists are likely to demand less Redemption Rights, which is favorable for entrepreneurs as well.

However, despite these benefits, corporate involvement can also have some distinctive drawbacks that have to be seriously considered by entrepreneurs when negotiating the terms of the investment. First, given the fast pace of technological development nowadays, corporations involved in venture capital want to have a fast and flexible option to acquire one of their portfolio companies in case the company's technology has proven itself. In order to accomplish this, and to avoid third parties 'running away' with the benefits, Corporate Venture Capital investors will normally demand an investor's Right of First Refusal to be inserted in the Term Sheet. More importantly, as a consequence of modern-day technology being highly sensitive to competition, corporate investors will want to have an option to conduct an acquisition fast and at their preferred moment. Therefore, they may wish to negotiate a "call option" that gives them the right to acquire the remaining shares held by founders and other shareholders at an agreed valuation.[224] As a response, founders may wish a corresponding right that "puts" their shares to the corporate investor in order to require it to acquire the founders' shares at similar terms. This may seem an attractive position for founders as it provides them a secured exit

[222] *Arcot, S.; 'Participating Convertible Preferred Stock in Venture Capital Exits', FMG and London School of Economics, February 2005.*

[223] *'The Disadvantages of Corporate Venture Capital', THE HOUSTON CHRONICLE, March 27, 2013.*

[224] *'The Disadvantages of Corporate Venture Capital', THE HOUSTON CHRONICLE, March 27, 2013.*

opportunity. However, when agreeing on call- and put-options to be inserted in the Term Sheet, founders lock themselves in to a sale to one suitor, thereby risking to be deprived from more profits in the situation that 1) other parties are willing to pay more for the company, or 2) the corporate investor acquires the company at a relatively low value, way before it reaches its full potential and can wholly fruition the technology is has developed.

5.3.4. Investor Control Rights

Second, as a consequence that both Corporate Venture Capital funds and Collaborative Corporate Venture Capital partnerships are predominantly furnished to facilitate a future acquisition of successful portfolio companies, an important conflict of interests might occur. [225] This conflict of interests is caused by a very distinctive characteristic of Corporate Venture Capital: the fact that the venture capital investor and the potential acquirer are both the same party, i.e. the corporation. In the situation of 'traditional' venture capital-backed companies, both the entrepreneur and the investor normally want the business to be valued as high as possible in order to maximize their returns. However, in the situation of Corporate Venture Capital, the corporation usually prefers the company's valuation to be as low as possible in order to acquire it at a bargain. This conflict of interests has the potential to turn out very harmful for entrepreneurs, as corporate investors now have an incentive to frustrate the company's development in order to depress its value. To mitigate this risk entrepreneurs should carefully consider the magnitude of the Control Rights they grant to corporate investors, such as Rights of Consent, Board Appointment Rights and Voting Rights. Despite the fact that directors are in most jurisdictions legally obliged to act in the company's best interest, the scope of the company's 'best interest' could very well be interpreted differently by corporate investors and entrepreneurs.[226] Therefore, entrepreneurs could insist on allowing investors solely to appoint Board Observers, instead of Board Directors with executive powers. Additionally, entrepreneurs may try to broaden the mandate of the company's Board of Directors at the expenses of investors' Rights of Consent and Voting Rights, in order to avoid the situation in which corporate investors try to veto every important board-decision or shareholder vote.

5.3.5. Information Rights and Confidentiality Agreements

Third, Corporate Venture Capital can be used by corporations to keep an eye on possible competitors and competitive trends as well. Corporations could for example invest in a lot of start-ups that are active in the same line of business in order to monitor their technology more closely. To achieve this, corporate investors could abuse their Information Rights as a shareholder or their rights to appoint certain people within the company (such as Directors or Board Observers), in order to obtain sensitive

[225] *'The Disadvantages of Corporate Venture Capital', THE HOUSTON CHRONICLE, March 27, 2013.*

[226] *The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets', p.19.*

information about the company's operations. Therefore, it could be useful for entrepreneurs to have a close look at the scope of the Information Rights and to make sure all (key)employees sign Confidentiality Agreements with the company.

With regard to the aforementioned, it should be emphasized that the intentions of Corporate Venture Capitalists are normally not as bad as stipulated in this section. However, by closely considering which terms to include in the investment Term Sheet, entrepreneurs can mitigate the potential risks of doing business with corporate investors. And while most pre-discussed recommendations will likely turn out to be superfluous, it is better to be safe than sorry, right?

5.3.6. More Entrepreneur-favorable Deal Terms

Finally, arguably the most interesting potential impact of the rising popularity of trade sales on the term sheet has to do with entrepreneurship-encouraging incentives. As discussed before, a successful IPO offers entrepreneurs the opportunity to regain control over the company they have founded. In contrast, in the event of a Trade Sale the acquirer will usually obtain control over the company. This important difference can have a significant impact on entrepreneurs, because the opportunity to regain control is deemed to be a powerful entrepreneurship-encouraging incentive much beyond the purely financial gains that can possibly arise out of starting your own business.[227] Because doesn't every entrepreneur wants to replicate the success of people like Larry Page (Google), Jef Bezos (Amazon) and Mark Zuckerberg (Facebook) that found their own business, took it public, became a billionaire and managed to regain and maintian control over 'their' company.

To provide the necessary stimuli to potential founders and key-employees in order to compensate for the loss of this important entrepreneurship-encouraging incentive is perhaps the biggest challenge for the venture capital industry.[228] One could argue that inserting more entrepreneur-favorable provisions in the Term Sheet may provide a partial solution to this problem. By allowing founders (and key-employees) to maintain more ownership and participation rights you could arguably compensate the loss of other incentives. However, at this moment it is almost impossible to determine whether this strategy is successful in counterbalancing the loss of one of the most important entrepreneurship-encouraging incentives.

[227] *Arcot, S.; 'Participating Convertible Preferred Stock in Venture Capital Exits', FMG and London School of Economics, February 2005.*

[228] *Mendoza, J.M. and Vermeulen, E.P.M.; 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity', May 3, 2011, p.12.*

5.4. Developments of the Term Sheet: the shift towards more Entrepreneur-favorable Deal Terms

As stipulated before, the structure and content of the term sheet provisions both heavily depend upon the individual negotiation position of the parties, the situation and prospects of the company and the economic environment at the time of the investment. Although the venture capital industry has not delivered very inspiring results over the past decade, and statistics about current global venture capital market performance (amount invested, number of deals, number and value of IPO's and trade sales, median time from initial venture capital financing to exit, etc.) have shown virtually no signs of revitalization since the financial crisis of 2008, paradoxically there currently seems to be a spirit of faith and optimism in the market.[229] And this positive spirit appears to be significantly favoring entrepreneurs.

This might seem surprising, as one could think that these uninspiring returns should make venture capital investors demanding a bigger slice of the pie (by requiring more liquidation preferences, anti-dilution protection, accruing dividends, etc.), but the opposite appears to be true. This shift towards more entrepreneur-friendly deal terms could be partially explained by the increased bargaining power of entrepreneurs. As discussed before, the emergence of more easy accessible forms of 'venture capital' (such as crowdfunding and incubators and accelerators) and the decreased likelihood of an IPO as exit event (and consequently the decreased likelihood that the entrepreneur can regain control over the company in the future) could both be a partial explanation for this phenomenon. However, there seem to exist more valid reasons that could account for the increased bargaining power of entrepreneurs and the subsequent shift towards more entrepreneur-favorable venture capital deal terms.

First, as a result of the fact that venture capitalists are increasingly financing companies at a more matured stage of their development, the potential of the company is more evident and the risk involved usually less significant. Therefore, entrepreneurs can negotiate better terms, can keep more of the business and retain more control.[230]

Second, as a consequence of the fact that institutional investors are pouring fewer money in only high-quality funds, the weaker, less reputable venture capitalists have more difficulties securing funding from limited partners and are replaced by more easily accessible sorts of 'venture capital' such as crowdfunding. As a result, the venture capitalists that remain active are the more experienced and reputable ones, the ones that have the most expertise in making innovative start-ups grow. Therefore, these venture capitalists will have the most promising start-ups coming to them and as a consequence do not have to oblige the entrepreneur to agree with too investor-favorable deal terms: they know that

[229] *'Current Contractual Terms and Market Conditions for Venture Capital', Pöllath+Partners LLP, February 2013.*

[230] *'Why 99% Of Entrepreneurs Should Stop Wasting Time Seeking Venture Capital', FORBES, July 22, 2013.*

keeping these promising entrepreneurs incentivized by granting them a fair 'slice of the pie' will eventually generate the highest returns.

In order to provide a brief, comprehensible overview of the shift towards more entrepreneur-favorable deal terms, the changing content and numbers of three of the most heavily negotiated venture capital deal terms will be discussed hereafter: the Liquidation Preferences, the Dividend Rights and the Anti-dilution Protection.

5.4.1. Liquidation Preferences

It is interesting to see changes in the way liquidation preferences are being used in venture capital financings. As thoroughly discussed in chapter IV, liquidation preferences provide investors with the right to receive a percentage of the company's proceeds in the event of liquidation (or other situations covered by the liquidation preference). Due to the fact that investors have incurred risk by providing financing to the company, certain additional liquidation rights are normally attached to the company's preferred stock in order to give investors a return on their investment that compensates for this risk: multiple liquidation preferences and (fully) participating liquidation preferences. It may be clear that liquidation preferences with high multiples and fully participating rights are very investor-favorable. It is therefore interesting to see that data[231] gathered from hundreds of venture capital financing transactions in the period 2009-2013 shows that these investor-favorable liquidation rights have become less common.

First, Multiple Liquidation Preferences have become less commonly used and the multiple used has decreased in most cases (from a 1,5x – 5x multiple in 2009 to a 1,5x – 2,17x multiple in 2013).[232] Instead, investors seem to increasingly demand a certain interest return (usually between 5% and 20%) on their preferential investment.[233]

Second, although not unusual, Fully Participating Liquidation Preferences are found in the minority of venture capital financings. Moreover, their number has been declining steadily over the past few years. Currently, only 8% of Series A Preferred Shares has Fully Participating Liquidation Preferences (was 30% in 2009), while only 24% of Post-Series A Preferred Shares enjoys these rights (was 57% in 2009).[234] Interestingly, the venture capital financings that still use Fully Participating Liquidation Preferences are increasingly putting 'caps' on the maximum amount of proceeds that can be distributed to the holders of preferred shares. By inserting these caps, parties avoid the situation in which investors benefit disproportionately from their Fully Participating Liquidation Preference (by receiving their liquidation preference and benefitting unlimited from the pro-rata division of the

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[231] *'2014 Venture Capital Report', WILMER CUTLER PICKERING HALE & DORR LLP, February 2014, p. 18.*

[232] *'2014 Venture Capital Report', WILMER CUTLER PICKERING HALE & DORR LLP, February 2014, p. 18.*

[233] *'Current Contractual Terms and Market Conditions for Venture Capital', Pöllath+Partners, February 2013.*

[234] *'2014 Venture Capital Report', WILMER CUTLER PICKERING HALE & DORR LLP, February 2014, p. 18.*

company's remaining proceeds). Currently, the Fully Participating Liquidation Preference of 50% of Series A Preferred Shares is capped (was 25% in 2009), while the Fully Participating Liquidation Preference of 41% of Post-Series A Preferred Shares is capped (was 35% in 2009).[235]

Based on the aforementioned changes, it is fair to say that investors, when negotiating Liquidation Preferences, currently seem to prefer securing the investment itself (return OF investment) over maximizing returns in case of a liquidation event (return ON investment).

5.4.2. Dividend Rights

Another important indication that underwrites the assumption that the deal terms in venture capital financings are gradually becoming more entrepreneur-friendly, can be found when looking at Accruing Dividends provisions. The Accruing Dividends represent a future obligation of the company to the holders of preferred shares that can significantly reduce funds available for holders of common stock (i.e. founders, key-employees, etc.).[236] Accruing Dividends can be considered very investor-favorable and the fact that their presence seem to be declining should therefore be heralded as a positive development for entrepreneurs. Currently, in only 9% of venture capital financing transactions Accruing Dividends are granted to the holders of Series A Preferred Shares (was 41% in 2009), while the holders of Post-Series A Preferred Shares enjoy Accruing Dividends in 11% of transactions (was 41% in 2009).[237] As a consequence of the fall of Accruing Dividends, much more money 'will be left on the table' for entrepreneurs and other holders of common stock in the situation of a liquidation event or a redemption of the preferred stock.

5.4.3. Anti-Dilution Protection

In addition to investors' Liquidation Preferences and Dividend Rights, their Anti-Dilution Protection seems to become more entrepreneur-favorable as well.

As discussed in chapter IV, investors_seek to protect themselves against dilution either through Full-Ratchet or Weighted Average provisions. The most investor-favorable Anti-Dilution Protection is the Full-Ratchet Protection. This form of protection completely safeguards investors from the diluting effects of an investment down round. The other commonly used form of Anti-Dilution Protection, the Weighted Average Protection, is more entrepreneur-favorable and can be found in two distinctive forms that provide different levels of protection: Broad Based Weighted Average Protection and Narrow Based Weighted Average Protection.

Although still quite commonly used in Europe and other parts of the world, Full Ratchet provisions can be found in only a small part of American venture capital financings. Moreover, Full-Ratchet

[235] *'2014 Venture Capital Report', WILMER CUTLER PICKERING HALE & DORR LLP, February 2014, p. 18.*

[236] *'Venture Capital Term Sheet Negotiation – Part 3: Dividends', Strictly Businesss Law Blog, November 7, 2013.*

[237] *'2014 Venture Capital Report', WILMER CUTLER PICKERING HALE & DORR LLP, February 2014, p. 18.*

provisions are increasingly replaced by Weighted Average provisions in venture capital financings on both continents.[238] In this respect, it is remarkable to see the rise of the Broad-Based Weighted Average Protection. This type of protection, almost non-existent until recently, is much more advantageous for entrepreneurs and is increasingly used in venture capital financings. [239]

This entrepreneur-favorable development of the Anti-Dilution Protection seems to imply that investors are more and more inclined to accept that future negative value developments of portfolio companies fall under the scope of the risk they take by making venture capital investments, and therefore should not be completely compensated for at the expenses of entrepreneurs and other shareholders.

[238] *'2014 Venture Capital Report', WILMER CUTLER PICKERING HALE & DORR LLP, February 2014, p. 18.*

[239] *'Current Contractual Terms and Market Conditions for Venture Capital', Pöllath+Partners, February 2013.*

Chapter VI: Conclusion

As stipulated before, the structural underperformance of the IPO-markets and the subsequent delivery of uninspiring returns by venture capitalists, that started after the burst of the dot-com bubble in 2000/01 and were aggravated by the financial crisis of 2007/08, have caused some notable alterations in the way global venture capital industries are functioning. These alterations, said by some to have caused the emergence of a ‘new venture capital cycle’, not only led traditional venture capitalists to change their investment behavior towards the less risky financing of later-stage companies, but resulted in the emergence of a new breed of venture capital investors as well. Most notably, online crowdfunding platforms, super-angels and incubators and accelerators, have surfaced on a global scale, while governments and large corporations are increasingly stepping-up their involvement in the venture capital industry. Additionally, secondary market trading is gaining more and more ground as an alternative liquidity provider and popular exit-strategy for both investors and entrepreneurs.

With regard to these developments, it is interesting to notice some remarkable changes in the appearance and accessibility of the venture capital term sheet, the behavior of venture capital investors and, most importantly, the content and magnitude of certain important term sheet provisions.

First, as analyzed in the first paragraph of chapter V, the increased presence of more easily accessible sources of financing, such as crowdfunding and incubators and accelerators, has led ‘traditional’ venture capitalists to come up with term sheets that are more entrepreneur-friendly and better comprehensible. These ‘new’ term sheets do not contain overly complicated and unnecessary jargon anymore, but are understandable for entrepreneurs (written in plain English) and better accessible (directly downloadable from investors’ website).

Additionally, in order to restore trust in the industry and to better compete with new forms of easily accessible venture capital, some reputable venture capitalists in Silicon Valley, such as Jason Mendelson and Gil Dibner, have created a so-called Venture Capital Code of Conduct. And despite the fact several national venture capital associations already make use of certain behavioral standards, the fact that venture capitalists are imposing higher ethical standards on themselves provides an excellent example of a more positive and civilized attitude in the industry.

Secondly, the second paragraph of chapter V has addressed the impact of the risen esteem of secondary market trading as exit strategy among both entrepreneurs and investors. The fact that well-functioning secondary market venues significantly increase the liquidity of portfolio companies’ shares, has certain implications that have to be taken into consideration while negotiating the terms of investment. As said before, in order to keep the interest of both parties more or less aligned, and to avoid situations in which one of the parties becomes less incentivized to perform, term sheet provisions such as Share-Transfer Restrictions, Tag-along Rights, Vesting Schedules and Board Approval Provisions will become more extensive and important.

Thirdly, paragraph 3 of chapter V has shed some light on the extent to which the term sheet is being influenced by the declining popularity of the IPO, the rising popularity of the Trade Sale as preferred exit strategy and the growing level of corporation-participation in the venture capital industry. It is worth noticing that, besides some formal changes in the structure and magnitude of deal terms such as Automatic Conversion Rights, Registration Rights, Rights of First Refusal and Investor Control Rights, the aforementioned developments could potentially lead to the insertion of more entrepreneur-favorable deal terms to compensate for the loss of entrepreneurship-enhancing incentives that derive from the fact that an IPO as exit event has become generally unavailable (and undesirable?) in most cases.

Finally, and most importantly, this thesis highlights that the recent changes and developments in the venture capital industry, that altogether caused the emergence of the 'new venture capital cycle', have seemingly resulted in a shift towards more entrepreneur-favorable deal terms in venture capital financing contracts. As proven by the data discussed in chapter V, the numbers, magnitude and content of certain key-provisions in the term sheet appear to be moving more and more in the direction of the entrepreneur. This positive, entrepreneur-favoring spirit is mainly driven by two forces. First, as a result of the fact that venture capitalists are increasingly financing companies at later, more matured stages of development, their potential is already more evident and the risk involved less daunting. Therefore, entrepreneurs have more bargaining power: they can negotiate better terms, can keep a higher percentage of ownership and retain more control. Second, As a consequence of the hard times faced by the venture capital industry over the last couple of years, the numbers of weak, less reputable venture capitalists have been drastically reduced. As a result, the venture capitalists that remain active are the more experienced and reputable ones, the ones that have the most expertise in making innovative start-ups grow, and the ones that are aware that keeping promising entrepreneurs incentivized by granting them a fair 'slice of the pie' will eventually generate the highest returns.

In summary, as emphasized throughout this paper: the 'new capital cycle' has led to a more entrepreneur-favorable investment environment. Term sheets have become increasingly easily accessible, transparent and comprehensible, venture capital investors have initiated to impose behavioral restrictions on themselves and, most importantly, a clear tendency towards more entrepreneur-favorable terms and conditions in venture capital financing agreements, can be observed. Venture capitalists seem to realize on an increasing scale that demanding the biggest slice of the pie is not always the most profitable strategy, and the fact that they appear to be more inclined to agree on equal and fair deal terms should therefore be heralded as a clear sign of a positive climate change in the way venture capitalists do business. A climate change that does not only serve the interests of entrepreneurs, but has the potential to benefit the entire venture capital industry as well.

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