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'The Term Sheets of Business Angels and Venture Capital Investments in High-Tech Start-Ups Compared and the Consequences of the Recent Market Developments to the Term Sheet'

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Abstract

High-tech start-ups have different stages of development and along with these stages different investors can be of significant importance. These investors use the term sheet to control and protect their investment from agency costs and moral hazard problems. This thesis looks into the term sheet with the view from different investors. A comparison of the term sheet is made and the differences are explained on the basis of the relationship between entrepreneurs and investors. Also the latest developments in the start-up financing world are discussed and in particular the emerging secondary market. Finally, these developments can have consequences to the provisions in the term sheet which will be explained and suggestions are done on how to deal with these changes.

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1. Introduction

Entrepreneurs with a technological business idea need financial support to develop the idea into an actual business in order to make it a success. Every entrepreneur believes that his business idea is going to be the new Google, Amazon, Apple computers or Ebay, but to have similar success like these venture backed companies, entrepreneurs have to understand who the right investor is and understand its terms of investment. These terms of investment are outlined in the term sheet. The term sheet is the most important document between the start-up and the investors, it establish the framework for interaction between investors and entrepreneurs, the company governance and has a significant impact on the entire start-up.[1] Different investors use different terms in their term sheet and when choosing the right investor, entrepreneurs should consider which suits their start-up best. Crucial considerations for entrepreneurs are which investor suits the situation and stage the start-up is in and what exit a start-up is heading to.

As technology is rapidly developing, so is the start-up financing world. Especially since the financial crisis which meant a decline in success stories for venture capital funds. Venture capital funds faced a drop in IPOs which was the exit venture capitalists preferred due to their high returns on investments it facilitated. Also new type of investors such as incubators, accelerators, angel groups and new generation of venture capital funds such as pledge funds, fund of funds and corporate funds arise. A secondary market for private equity shares is emerging and these factors can influence the terms investors offer in their term sheet and thus these developments play an important role in deciding what the best investment for the start-up is.

This thesis is trying to find an answer to the question what the differences are of the term sheets offered by different investors and if the recent developments in the financing world, including the secondary market, can have consequences to these term sheets. In chapter two traditional business angels' characteristics are discussed and the development of angel groups is explained. In chapter three the venture capital model and its recent developments concerning the poor exit market and the emerging secondary market is explained. In chapter four the provisions of the term sheet are explained and in chapter five the term sheets of traditional business angels, angel groups and venture capital funds are compared. Also discussed in chapter five is the development of the start-up financing world and if this has any consequences to the term sheet. Finally chapter six is concluding and answering the main question what the

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[1] B. Peters, 'The evolution of the Term sheet part 1 a Seminar for Bellingham Angel Group' November 17 2009. *Exits.com* available at <http://www.exits.com/blog/angel-term-sheet-evolution-part-1>

differences are between angel and venture capital term sheets, what explains these differences and what the consequences of the secondary market can be to the term sheet.

2. Traditional Business Angels

2.1 Traditional Business Angel investments

Traditional business angels are investors who during their active career became wealthy individuals with business experience and are willing to invest this in an early stage of a company in order to support entrepreneurs in return for stock in the company.[2] In the earliest stage of a start-up, the founders, their family and friends are investing in the start-up business. But when these resources are no longer sufficient and the start-up is ready for the next stage, new investors have to come in.[3] For venture capitalists it is too early to invest and the appropriate amount that is required is too small for them to invest. This leaves the start-up with a funding gap, a gap that can be filled by the business angel.[4] The funding gap can differ from $50 000 to over a million dollars, depending on the start-up and the type of business. Business angels are filling this gap with their private assets if they see potential for success in a start-up.

The traditional business angel does not only provide money to the start-up, they also contribute important knowledge, skills, expertise and contacts.[5] They introduce the entrepreneurs to potential customers and investors, see around potential problem areas and help the start-up gain credibility in their field. But most important is that they provide it at a crucial stage in the start-up's growth that allows entrepreneurs to build the financial bridge from friends and family funding to venture capital funding. Without financial and nonfinancial assistance during their first years, many start-ups will fail to develop to the point of attractiveness for venture capitalist. Angels are crucial in the start-up stage of companies because they fill the funding gap as to both time and capital, functioning as a 'conveyor belt' that moves start-ups towards waiting venture capitalists.[6]

Business angels look for new innovative companies that can grow in size and value.

[2] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1406

[3] Different stages can be distinguished in start-up financing. First stage is the *Seed stage*, where the idea needs to be developed and proven. The *Start-up Stage* where the idea is ready for commercializing. The *Early Stage* where the production and distribution of a certain product or service can take place. And *Later Stage* where the company is matured, profitable and continuously growing. In the thesis, when we talk about start-ups we refer to the earliest stages till the moment where the company is matured.

[4] V. Ramadani, 'Business Angels, Who They Really Are?', *Strategic Change: Briefings on Entrepreneurial Finance,* Vol. 18, Nos. 7-8 (2009) p. 7-9

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

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

They invest in the first years of the start-up company and in these first years, the risk is highest due to no operating history of the company. The amount traditional business angels invest individually in a company differ from $50.000 to $2 million depending on what business and which area.[7] But because angel investments occur more often, the total investments done by business angels transcends venture capital investments.

The importance of business angels is often underappreciated, where venture capitalist are credited for the success stories of Silicon Valley such as Google, Ebay, Amazon.com and Apple Computers but all of these companies relied on business angels before venture capitalists came in. Next to this, the business angels were the ones who attracted the venture capital investors with their investment. Over the past several years, the number of companies funded by angels have increased from 50 000 to almost 70 000 annually in the US but the average deal size has decreased from $500 000 to $350 000.[8] The quantity of angel investments transcends the quantity of venture capital but logically the amount of venture capital investments transcends the total amount of business angels due to the higher amount per investment.

When business angels invest in a start-up, uncertainty, risk, information asymmetry and entrepreneurial opportunism are always involved.[9] Information asymmetry can be explained as a reoccurring problem when one is investing and another is executing the business in which the money is invested. There is a difference in knowledge on how the company is performing and how the invested money is spent. In case of investment of a business angel, it is a big risk because the angel cannot rely on any history on performance of the company. The entrepreneur has a powerful position in the light of information asymmetry compared to the business angel who is investing in the start-up. Entrepreneurial opportunism can be explained as the overvaluation of its start-up and how it is going to perform in the future. Most entrepreneurs look too bright at their start-ups and they truly believe their start-up is going to be the new Google or Apple Computers. This happens frequently when entrepreneurs do not have any business experience.

Entrepreneurial opportunism is harmful for business angels when they invest in the start-up, the entrepreneur may have different ideas on the amount needed and how to spend the

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[7] OECD (2011), *'Financing High-Growth Firms: The Role of Angel Investors'*, OECD Publishing p. 23 available at <http://dx.doi.org/10.1787/9789264118782-en >

[8] J. Sohl, 'The Angel Investment Market in 2011: The Recovery Continues', Center for Venture Research (2012) & Bill Payne, 'Average Round Size in Angel Deals', gust.com Blog: 'Thoughts on Start-ups by Investors that Fund Them & Entrepreneurs that Run Them.' Jan 26 2012, available at <https://gust.com/angel-investing/startup-blogs/2012/01/26/average-round-size-in-angel-deals/ >.

[9] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1420

investment. These agency costs can be mitigated with comprehensive investment contracts, which allow investors to screen, monitor and control their investments, as venture capitalists do. But as traditional business angels invest with relatively small amounts and are less sophisticated compared to venture capitalists the agreement is an informal one.[10] A comprehensive agreement would be too expensive and time-consuming according to the costly contracting theory.[11] Business angel investments have always been done by simple contracts, despite the high level of uncertainty, information asymmetry and agency costs, business angels do not extract any of the venture capitalists' common contract protections.[12] According to the financial contracting theory, this is due to the fact that business angels might be experienced and skilled entrepreneurs, but compared to venture capitalists they have no experience on how to monitor and control an investment.[13] But Ibrahim suggests on the other hand, that the use of formal and simple contracts by business angels is rational from a financial perspective. In my opinion Ibrahim is right; the contracts of business angels are formal and simple due to a rational. Considering that most business angels have wide portfolios it is firstly too expensive to enter in a comprehensive contract for every investment they do and the duration of these investments are not long of duration. Secondly, when business angels would invest in a comprehensive contract, it would be harder to bring the start-up to a second round of financing. When these comprehensive contracts have to be dissolved when the venture capitalists want to receive their standard preferences, venture capitalists would reconsider to invest in this start-up. The Business angel recognizes he is the first but not the last source of investment and therefore would not enter in such a comprehensive contract.

Next to this, business angels screen and monitor start-ups by active participation in the business. Therefore a comprehensive contract with monitoring and screening provisions is not necessary for the business angel. The business angels can easily monitor and screen the entrepreneur and the start-up by regularly dropping by and join to meetings.

Finally, business angels are not investing particularly for the returns on investment. Business angels, as we have seen, have several motivations for investments which are frequently more important than financial reasons and these will be explained below. These non-financial motivations such as excitement and giving something back to the community do not

[10] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 141

[11] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1433

[12] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1408

[13] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1408

need contractual security. This explains the informal contracts for business angels as well. In chapter five this will be more closely explained.

2.2 Traditional Business Angel Motivation for investments

Traditional business angels have several motivations for investing in start-up businesses. The basic principal of investment is the return on investments which is one reason for an angel to invest. The average return rate on investment for business angels is between 20 to 30%, but considering that the possibility of success is actually 48% this return covers the risk.[14] Most angels invest in a portfolio of start-up companies to spread the risk; the portfolio differs from one for unsophisticated angels till over ten investments for the most sophisticated angels. [15]

But a more important motivation than return on investment is the fact that after being a successful entrepreneur and gaining lots of wealth, knowledge and expertise in their working life, it can be hard for a business angel to be passive and let these acquired skills perish. Their money and skills can be useful to young entrepreneurs and besides this, by investing in start-up companies they put themselves in function again. Angels feel the obligation to transfer their knowledge and experience to the new generation of entrepreneurs and make sure not to make the same mistakes as the angel did while he was an entrepreneur, so the young entrepreneurs too can succeed to make a successful business.[16]

Next to being out in the field again supporting young entrepreneurs, angels are investing for fun, pleasure and excitement. When they see the business growing due to their money, network and advice, this is a great satisfaction for business angels. [17]

Also angels feel a certain responsibility for the economic development in the region and by supporting innovative start-ups they contribute to innovation and employment in the region.[18]

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[14] J. Sohl, 'The Angel Investment Market in 2011: The Recovery Continues', Center for Venture Research (2012) & Witbank, Robert, *'Angel Investors Do Make Money, Data Shows 2,5x Returns Overall',* Blog: 'Thoughts on Start-ups by Investors that Fund Them & Entrepreneurs that Run Them.' gust.com Oct 17 2012 . Available at <https://gust.com/angel-investing/startup-blogs/2012/10/17/angel-investor-returns/#more-2193>.Data shows that angel investors make money with an average return of 2,5 times their investment overall.

[15] Payne Bill, **'***Investment strategies for Angels'*, Blog: 'Thoughts on Start-ups by Investors that Fund Them & Entrepreneurs that Run Them.' Gust.com Feb 23 2012. Because of the high-risk investments angels do, they spread these risky investments. This creates a wide portfolio which angels need to beat the odds of failure. Available at <https://gust.com/angel-investing/startup-blogs/2012/02/23/investment-strategy-for-angels/#more-789>

[16] V. Ramadani, 'Business Angels, Who They Really Are?', *Strategic Change: Briefings on Entrepreneurial Finance,* Vol. 18, Nos. 7-8 (2009) p. 7-9

[17] V. Ramadani, 'Business Angels, Who They Really Are?', *Strategic Change: Briefings on Entrepreneurial Finance,* Vol. 18, Nos. 7-8 (2009) p. 7

[18] Payne Bill, '*Motivations for an Angel Investor'*, Blog: 'Thoughts on Start-ups by Investors that Fund Them & Entrepreneurs that Run Them.' Gust.com Feb 16 2012. Available at <https://gust.com/angel-investing/startup-blogs/2012/02/16/motivations-of-an-angel-investor/>. On his blog Bill

Facts show that most angels invest in start-ups that are located in the region which they are living or working, so they can easily visit the start-ups and provide the entrepreneurs with advice on a regular basis. By investing in the region, angels give something back to the entrepreneurial community that made them wealthy, and besides this, angels are contributing to the region's economic development.[19]

The reason for this wide variety of motivations for investments can be explained by the fact that there is a wide variety of different business angels as well. Every angel has his own motivation, whether it is about return on investment, angels want to stay active in the business, transferring their knowledge and skills or just because for fun and excitement.

2.3 Entrepreneurs Motivation for Business Angel Investment

Entrepreneurs of start-up companies can have important reasons for choosing investments by business angels. Choosing the right type of money matched to the risk involved is crucial for a successful business. Start-up with no income in the first years, are best served with private equity investments, such as business angels provide. Choosing for debt financing, the entrepreneur agrees to pay back the debt including interest rates. For a start-up this is a poor starting position, with no money coming in during risky and uncertain years, start-ups already have to find ways to redeem the debt with interest.[20] Choosing for private equity, investors want to have returns on investment, and the real cost of private equity is the control on the start-up and the information a start-up needs to share with its investors (in case of venture capital backed firms). Business angels provide private equity for a return on investment, next to this they do not require special control rights. Information requirements will be provided automatically due to the relation between angels and entrepreneurs, which will be explained later on. The best money to choose for start-up is thus investment by private equity.

Having decided to choose for private equity, the start-up automatically ends up with business angels. Whereas venture capital funds invest in later stage and with larger amounts, business angels fill the investment gap resulting from the difference between the investment by family and friends and the investment of the venture capital. But besides filling this crucial gap

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explains that giving back to community and helping the local business grow are still one of the most important motivational reasons for angels. Besides this motivation, other motivations to support entrepreneurs with their knowledge and experience and because of the joy it gives them when working with young entrepreneurs.

[19] V. Ramadani, 'Business Angels, Who They Really Are?', *Strategic Change: Briefings on Entrepreneurial Finance,* Vol. 18, Nos. 7-8 (2009) p. 9

[20] R. Aernoudt, 'Business Angels: The Smartes Money for Starters? Plea for a Renewed Policy Focus on Business Angels', *International Journal of Business*, Vol. 10, No. 3, 2005, p. 273

for start-up they offer the so called ‘smart money’.[21] This means that angels do not only invest money, but also expertise and know-how. Due to this reason business angels are becoming more and more an interesting option for entrepreneurs.[22]

Next to the ‘smart money’, business angels also have lots of experience in their field of business. Most angels are former successful entrepreneurs and during their career they gained experience and created a network. When angels invest in a start-up, not only this start-up can use the money, know-how, expertise and experience, it can also use the network of the investing angel. The contacts of the investing angel can help developing the start-up and bring it to the next level.

Furthermore, when business angels invest in a start-up, he will be dedicated and committed to the start-up to make it a success and get a return on investment. Naturally the entrepreneur, who has already an amount invested himself, is dedicated to bring his start-up to a success. Both dedicated and motivated parties can get into a smart partnership which might lead the start-up to a higher level and even open doors to second round venture capital investment.[23]

As we have seen, angel investments are high risk investments and entrepreneurs have many reasons to choose for the investments of business angels. But not only the entrepreneurs benefits from angel investments; venture capital funds benefit from the risk-taking of angels as well. Due to the risk taking of angels, venture capitalists rely on angel funding to help start-ups develop and use angel funding as a mechanism for choosing among all the start-ups to find a company to invest in.[24] The due diligence process (and the investment as a result) done by the angels automatically triggers the attention of venture capital. Besides this, the start-up is due to the angel investment ready for the next stage of financing. Thanks to business angels, the venture capital model can exist in its current form.[25]

2.4 The Development of Business Angels; Angel groups

Since the beginning of investments done by business angels it was always considered an informal and more hobby-like activity instead of a professional business. These informal business angels were hard to find for entrepreneurs, which resulted in high search costs. The

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[21] D. M. Ibrahim, ‘The (Not So) Puzzling Behavior of Angel Investors’, *Vanderbilt Law Review* (2008), Vol. 61 p.1406

[22] V. Ramadani, ‘Business Angels, Who They Really Are?’, *Strategic Change: Briefings on Entrepreneurial Finance,* Vol. 18, Nos. 7-8 (2009) p. 11

[23] R. Aernoudt, ‘Business Angels: The Smartest Money for Starters? Plea for a Renewed Policy Focus on Business Angels’, *International Journal of Business*, Vol. 10, No. 3, 2005, p. 273

[24] D. M. Ibrahim, ‘The (Not So) Puzzling Behavior of Angel Investors’, *Vanderbilt Law Review* (2008), Vol. 61 p.1407

[25] D. M. Ibrahim, ‘The (Not So) Puzzling Behavior of Angel Investors’, *Vanderbilt Law Review* (2008), Vol. 61 p.1407

way to find informal angels was mostly by using ones network, but most young entrepreneurs do not actually have an established network. The difficulty of finding business angels has led to the description of angel investing as an 'invisible market'.[26] The market of business angels was not a well-known market, there was no data on how many angels there are active, how much and often they invested and in what kind of start-ups they invested their money in.

Another disadvantage of informal business angels is the wide variation of quality of angel funding. Most investments were done by non-professional angels, such as wealthy family, lawyers and accountants. These unsophisticated angels did not have the knowledge, skills and experience that former successful entrepreneurs have. This causes a distortion *ex ante* and *ex post.*[27] *Ex ante,* unsophisticated angels do not have the ability to select the most promising start-ups. Most unsophisticated angels invest because of a favor to friends and family instead of making a critical evaluation on a particular start-up. *Ex post* it causes problems in a way that the unsophisticated angels do not have the skills their sophisticated colleagues have. Therefore they cannot add-value to the start-up in a way the high sophisticated angel does and as a consequence failure of the start-up.[28]

Since the 1990's there was a bigger need for professional approach by angels towards entrepreneurs. Next to this, a second market gap occurred in the financing of start-ups. The venture capital industry developed to a larger and later stage financing market, starting from $5 million, and the informal business angels invested amounts up to $2 million.[29] The funding gap that occurred was from $2 million to $5 million and is generally more a capital gap than an information gap as the first funding gap in start-ups mentioned in part 2.1. These larger capital requirements in start-ups have created a new form of angel financing called 'Angel Groups'.[30]

Angel groups are organizations of large groups of individual angel investors, who are professionalizing the practice of angel investing and willing to fund the second funding gap.[31] Joined together, these angels evaluate and invest in start-ups. Although, angel groups differ in the amount they invest and how they find their investment projects from individual angels, the essential trait stays the same. As a group, they are removing the two main drawbacks of

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[26] D.M. Ibrahim, 'Financing the Next Silicon Valley', *Washington University Law Review* (2010), Vol. 87 p. 741
[27] D.M. Ibrahim, 'Financing the Next Silicon Valley', *Washington University Law Review* (2010), Vol. 87 p. 744
[28] D.M. Ibrahim, 'Financing the Next Silicon Valley', *Washington University Law Review* (2010), Vol. 87 p. 742
[29] J. Sohl & W. Rosenberg, 'The US Angel and Venture Capital Market: Recent Trends and Developments', *Journal of Private Equity* (2003) , Vol. 6, No. 2, p. 19
[30] Angel groups are alternatively referred to as Angel investment organizations, Angel Alliances, Angel Associations or other angel syndications.
[31] J. Sohl & W. Rosenberg, 'The US Angel and Venture Capital Market: Recent Trends and Developments', *Journal of Private Equity* (2003) , Vol. 6, No. 2, p. 19

informal angel investing. Firstly, organizations of angels are easier to find for entrepreneurs who are looking for funds for its start-up. Where individual angel investors are hard to find, angel groups are only a few mouse-clicks away because they have a bigger reputation and their own website providing information for potential members and entrepreneurs.[32] On the contrary of 'invisible markets' for formal angel investors, the market for angel groups is 'highly visible' which means the search costs for entrepreneurs reduces. Although angel groups still rely on references to find investments, they also use more formal mechanisms for finding investment opportunities. First they are pre-screening potential entrepreneurs. If this first examination looks promising, they invite the entrepreneur to make a presentation for all the members of the group. If any angel of the group shows interest in a potential investment of the start-up, the process progresses further with an investment in the end.[33] It is important to know that when one of the angels of an angel group sees potential in an investment but others do not, he can still do the investment individually. But when several angels are positive about a start-up they will invest together. Also when there is the need to fill in the secondary funding gap, angel can pool their investment in order to fill the funding gap. Angel groups make it possible to make more frequent investments and with a larger amount.

Next to the higher visibility, angel groups are able to offer entrepreneurs a higher quality experience due to their advantages as a collective. Because of their diversity of expertise and entrepreneurial experience, angel groups can add more value to start-ups *(ex post)* and has advantages in selecting the right start-ups *(ex ante).*[34] When questions arise or problems occur there is a high possibility that one of the members of an angel group had to deal with a similar problem before. Members of angel groups can rely on each other's expertise and knowledge and therefore be more successful than individual business angels.

As we have seen before, the contracts of individual business angels are informal contracts. But however the characteristics of individual angels and angel groups are similar, the amount and frequency of investments differ. As a consequence, the contracts of angel group are different from the one individual angels use. Angel groups have professionalized the angel start-up investing process, this is reflecting in the contracts they sign with the entrepreneurs. One can say that the contracts of angel groups have a closer resemblance with venture capital contracts than with individual angel contracts. Although angel groups are more visible than individual angels, there are not many empirical studies on angel groups. This is why it is hard to

[32] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1444; See for example http://www.techcoastangels.com/ or http://www.allianceofangels.com/
[33] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1445
[34] D.M. Ibrahim, 'Financing the Next Silicon Valley', *Washington University Law Review* (2010), Vol. 87 p. 744

tell what the typical angel group contract implies.

There are several reasons which explain why contracts of angel groups are more comprehensive and venture capital like instead of informal contracts. Firstly, the relationship between the entrepreneur and the group of angels is different. Whereas the relation between the individual angel and the entrepreneur was close and trustful, the individual angel could rely on trust and informal substitutes for a contract. But because angel groups have a more arms-length relationship with the entrepreneurs, they cannot rely on the pre-investment nature of the relationship. Instead angel groups have to rely on formal contracts which reduce the information asymmetry and uncertainty.[35]

Second, angel groups invest higher amounts due to pooling their investments and invest them in a later stage than individual angels. The costly contracting theory explains that investment contracts for smaller investments are too expensive and time-consuming. As we have seen above, this is one explanation for the informal contracts that individual angels use. But due to the fact that angel groups invest larger amounts, spending more to design, monitor, enforce, and write detailed contracts becomes worth the benefits it provides.[36]

Besides this angel groups have steady deal flow which causes them to manage more deals, one cannot manage every deal on trust with the entrepreneur and therefore one need a more comprehensive contract. Angel groups have better understanding of the venture capital process and abstain from overvaluing start-ups with the result if eliminating the venture capitalist most common complaint about angels. Angel groups are the equivalent of early-stage venture capitalist and they are contracting accordingly [37]

Finally, we have seen that return on investments is not the main reason why individual angels invest in start-ups. The excitement, giving back to the community and transfer their skills and network are more important to individual angels. These non-financial reason make it redundant to draft a comprehensive contract, an informal one is sufficient. But as angel groups have more interest in returns on investments, it is their interest to draft a more comprehensive contract which has specific provisions so they can screen and monitor the start-up.[38]

[35] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1449
[36] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1450
[37] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1449
[38] Angel groups have both financial and non-financial interest in investments, the financial motive is important but not the only important one. Non-financial motives are interaction with other angels and extending their network.

3. The Venture Capital

3.1 Venture Capital in general

Venture capitalists provide funding for high risk start-ups which have a high potential for growth on the long term. The funding is pooled by individual investors and managed by the venture capital for investments in start-ups that are too risky for the standard capital market or bank loans. Venture capitalists are investing in a wide portfolio of start-ups so they are spreading the risk of the funding of start-ups, instead of putting all their money on one entrepreneur. Venture capital funds play an important role in the risky financing of the development of technology based start-ups. Due to their funding, technological start-ups can develop into successful companies which contribute to the economic growth in a country. Venture capitalists come in at a later stage of start-up financing, after or alongside the business angels or angel groups. The amounts venture capitalists invest differs from $2 to $10 million and in a total of $196,9 billion capital under management in 2011.[39] Venture capitalists make equity investments into start-ups

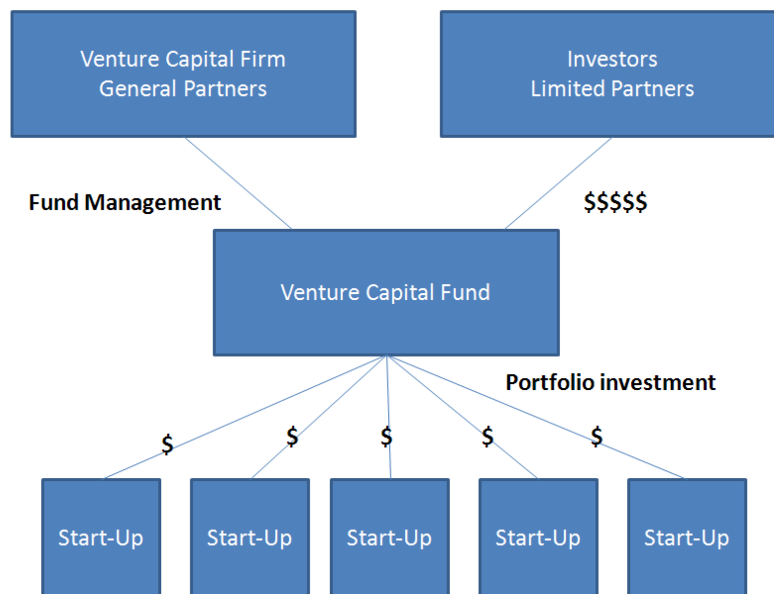

Figure 1
the structure of a Venture Capital Fund

who are at the time worthless because the start-up has to mature before making money, but when the start-up is matured and is acquired or goes public; the venture capital is making its money.[40]

[39] Thomson Reuters, '*National Venture Capital Association Yearbook 2012'* (2012) p. 9
[40] Thomson Reuters, '*National Venture Capital Association Yearbook 2012'* (2012) p. 9

The first signs of venture capital were during the 1960s in the US, were business angels joined forces and decided to invest together. During the 1980s and 1990s venture capital funds peaked due to the starting technological development, in the end of the 1990s the number of venture capital firms doubled in order to keep in the pace with the increase volume of the market and the size of individually venture capital funds grew at alarming rate.[41] But in the beginning of the 20th century the bubble exploded, private equity market crashed and shrunk till half its size. Since this, the venture capital market recovered steady.

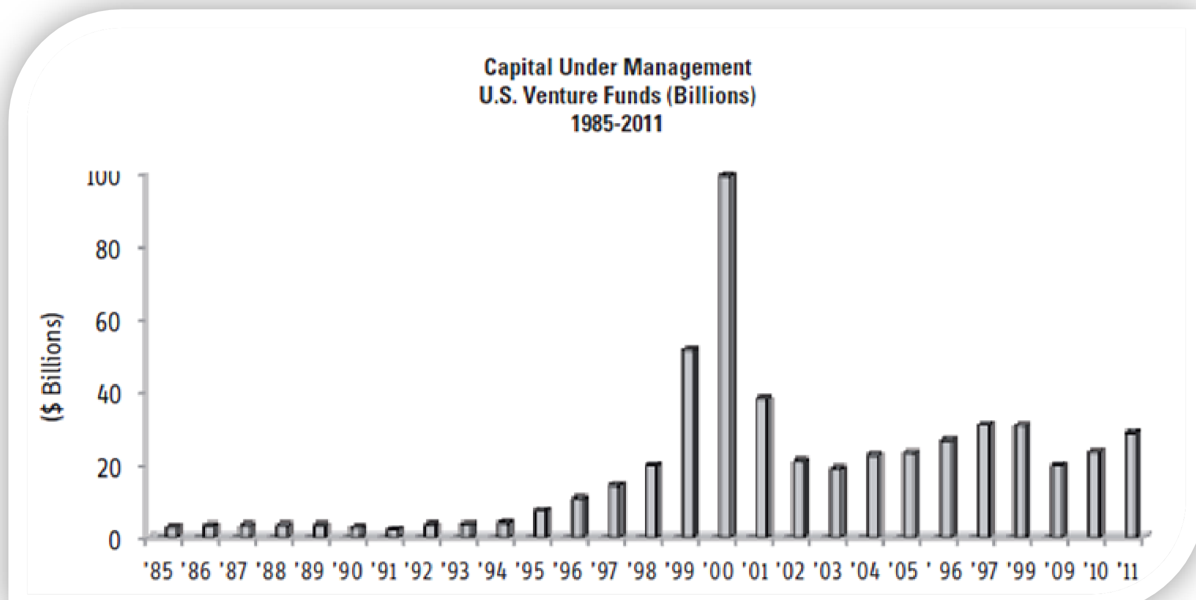

Figure 2
Source: NVCA Yearbook 2012

Venture capitalists traditionally invest in start-ups in high-tech industries, such as the software industry, biotechnology, industrial/energy industry and IT services. These industries are high-risk but high-potential when a company has the possibility to develop. Figure 3 below shows the US venture capital investments by industry in 2011.

[41] J.E. Sohl & W. Rosenberg, *'The US Angel and Venture Capital Market: Recent Trends and Developments'*, Journal of Private Equity (2003), Vol. 6, No. 2 p. 4

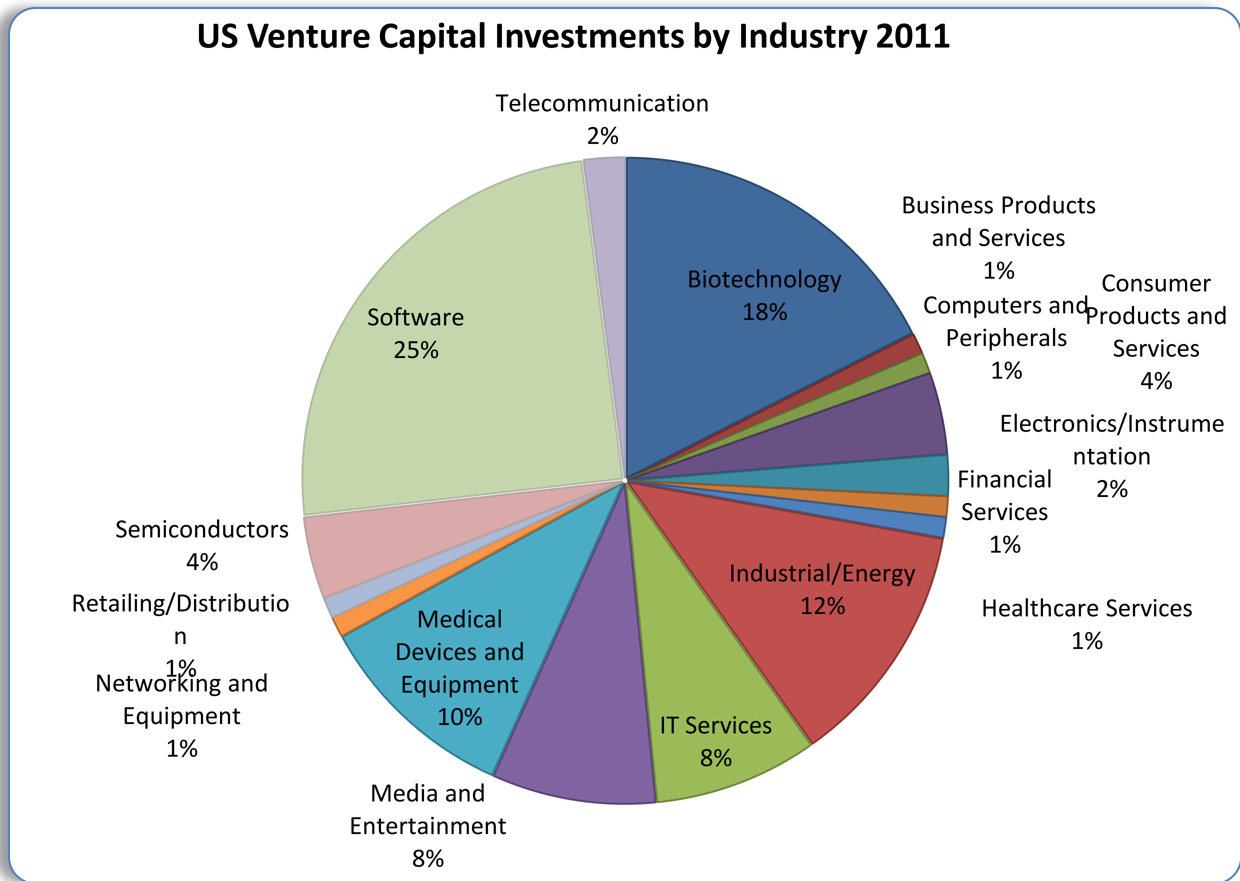

Figure 3
Source: NVCA Yearbook 2012

Venture capital funds differ from business angels because they are more formal business entities, with full time professionals seeking and funding promising ventures, while business angels are wealthy local individuals who make private investments and have a more informal relation with the company and entrepreneur.[42] Because venture capital is a more formal entity, they organize themselves in legal entities. In the US they are four main types of venture capital funds; The *Small Business Investment Companies* (SBICs), *financial venture capital funds, corporate venture capital funds* and *venture capital limited partnerships*. The venture capital industry is dominated by the venture capital limited partnership since the late 1980s.[43] In

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[42] W.L. Megginson, 'Towards a Global Model of Venture Capital?', *Journal of Applied Corporate Finance* (2004), Vol 16, No 1, p. 8

[43] J. A. McCahery & E. P. M. Vermeulen, 'Limited Partnership Reform in the United Kingdom: A competitive, Venture Capital Oriented Business Form, *Tilburg Law and Economics Center Discussion Paper,* No. 2004-024 p. 14 Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=664166> & W.L. Megginson, 'Towards a Global Model of Venture Capital?', *Journal of Applied Corporate Finance* (2004), Vol 16, No 1, p. 9

the limited partnership form, three groups of players can be distinguished. First there are the outside investors, second there is the venture capital organization and third the entrepreneurs.[44] The outside investors are the limited partners, together they pool their investments in order for the general partner to organize, invest, manage and ultimately liquidating the capital raised from the limited partners (See also Figure 1). There is a high degree of information asymmetry between the general partners and the limited partners.[45] As the general partners manage the investment and the limited partners are not able to monitor the venture backed start-ups.

Entrepreneurs choose for venture capital financing because venture capitalists, by funding the start-ups, can develop and expand its business. But besides funding, venture capitals also offer value-added services to the start-ups. They can provide the entrepreneur with valuable information, a network, experience and in the end facilitate an IPO. Since venture capital funds have dealt with lots of start-ups, gained experience, and created a network while dealing with the development of start-ups, they can be a mentor to entrepreneurs and help thinking strategically about how to expand the start-up. But venture capital investment can also have disadvantages for entrepreneurs. It can be really hard to find a venture capital that is willing to invest in your business, the entrepreneur needs to have a really good and solid business plan. Once you find a venture capital, you have to negotiate about the terms of investment, where the entrepreneur has no experience and the venture capital plenty. But the most important disadvantage for entrepreneurs in venture capital financing is the fact they give a part of ownership of the start-up to the venture capital. As we will discuss below, the venture capital will require board seats so they can control and monitor their investment. For the entrepreneur this means he has certain requirements to meet imposed by the venture capital, so the entrepreneur will feel the pressure of the venture capital investment.

Venture capitalists have different motivations to invest in high-tech start-ups. The main reason for venture capitalists is the high return on investment, the return rate is high due to the high risk involved. When the venture capital starts investing, they are investing in an idea that is at the time worthless but can develop into a successful business when the company matures for several years.[46] The venture capital guides the start-up with their knowledge, experience and network till they are acquired or go public. This is the moment where the venture capital requires its return on investment.

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[44] E.P.M. Vermeulen, *'Towards a New 'Company' Structure for High-Tech Start-Ups in Europe* (2000) p. 38. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=255619>

[45] E.P.M. Vermeulen & D.P.D. Nunes, 'The Evolution and Regulation of Venture Capital Funds'(October 17, 2012) *Lex Research Topics in Corporate Law & Economics* No. 2012-1

[46] Thomson Reuters, '*National Venture Capital Association Yearbook 2012'* (2012) p. 7

3.2 Venture Capital Investment in Preferred Stock

Besides funding, venture capitalists also provides valuable management and strategic advice to these start-up firms, which is useful to the entrepreneurs who often do not have these kinds of business experience.[47] Venture capitalists obtain these management and strategic roles because they invest and obtain preferred stock or convertible preferred stock, where other shareholders, employees and traditional business angels will receive common stock.[48] As a result of the preferred-owning venture capital frequently acquires substantial power over other participants in the start-up.[49]

Due to the preferred stock, venture capitalists receive extensive control rights when investing in start-ups.[50] These control rights such as the liquidation preference, right to veto changes in the certificate of incorporation, and the control in the board of the start-up gives the venture capitalists the possibility to control and monitor their investment.[51] Investing in start-ups is accompanied with uncertainty, high risks and agency costs. The principle-agent problem occurs, where the entrepreneur is the agent and the venture capital is the principle. The principle is required to take precautionary measures to ensure that the agent will be less inclined to act opportunistically.[52] There is an information asymmetry between the entrepreneur and the venture capital and entrepreneurial opportunism is something to look out for. Having priority to cash-flow rights and board seats mitigates the agency costs for the venture capital. The use of preferred stock is an incentive for the entrepreneur to generate value, and board control enables the venture capital to monitor and replace poorly performing managers.[53]

3.2.1 Common Shareholders in Control

Preferred stockholders in combination with the extensive control rights causes an unusual

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[47] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 102

[48] Convertible preferred stock is preferred stock that includes the option for the holder to convert to common stock. Traditional business angels invest in common, but nowadays more angels start to invest in preferred as well.

[49] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 104

[50] Fred Wilson, *Financing Options: Preferred Stock,* avc.com jul 18 2012. On his blog Fred Wilson explains that preferred stock provides certain rights and preferences to investors. It is a superior stock compared to common stock. http://www.avc.com/a_vc/2011/07/financing-options-preferred-stock.html.

[51] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 104

[52] J.A. McCahery & E.P.M. Vermeulen, 'Limited Partnership Reform in the United Kingdom: A competitive, Venture Capital Oriented Business Form, *Tilburg Law and Economics Center Discussion Paper,* No. 2004-024 p. 15. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=664166>

[53] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 105

corporate governance structure of venture-backed startups; the preferred stockholders, instead of the common stockholders, control the board and the company.[54] Normally, in private and public companies, the preferred shareholders do not have the right to elect the board of directors but the common shareholders do. The directors have a fiduciary duty towards the common shareholders, which means that the directors have to act in the best interest of the common shareholders. Concerning the preferred shareholders, the directors only have to respect the contractual rights but they do not have an obligation to act in their best interest.[55] This means the board of directors can, in a company not controlled by preferred shareholders, take decisions that favor the common shareholders but at the same time harm the preferred. Basically, general corporate law makes directors owe a fiduciary duty of loyalty to the corporation and all the shareholders regardless if they are common or preferred shareholders. But US Delaware law generally allows a board of directors which has both common and preferred shareholders to make business decisions that act in favor of the common but has a negative effect on the preferred, as long they do not violate the contractual rights of the preferred.[56]

It is desirable for a company to let the common shareholders elect the board of directors because common shareholders have the same interest as the company; maximizing corporate value.[57] Therefore when common shareholders act on their own behalf, this is automatically beneficial for the corporate value of the company.

Next to the fact common shareholders and the company have the same interest there is another reason why common shareholders should be in control. Preferred shareholders will set up contracts to protect their rights but as common shareholders do not have these protective contracts. Common shareholders are uniquely vulnerable for insider opportunism and therefore need to rely on the board they elected and the fiduciary duties of the board of directors. [58] Instead of protective contracts, they can protect themselves by choosing the right directors who they can trust and act in the interest of the common shareholders.

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[54] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 105

[55] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 109

[56] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 111

[57] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 113

[58] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 114

3.2.2 Preferred Shareholders in Control

As discussed, venture capital most often invest in preferred or convertible preferred stock. This gives the venture capital the possibility to monitor and control its investment. The convertible preferred stock gives the venture capital the option to convert their preferred into common stock. If they will do so, their converted stock will carry the same rights as the other common shareholders have. By keeping the preferred stock the venture capital fund keeps its substantial power to control and monitor its investement. Also preferred stock reduces information asymmetries that occur at the pre-investment stage. Before investing the entrepreneur might have more information about the actual value of the start-up and does not share this information with the venture capital. This creates the possibility that the entrepreneur sells its stock at an overvalued price to the venture capital.[59] In order to prevent such overvaluation during the pre-investment stage, the preferred stock contains a liquidation preference. The liquidation preference is a clause that enables favorable treatment for the preferred in case of liquidation.[60] It contains a value which is higher than the actual purchase price and as a result the entrepreneur will not profit unless the value of the company turns out to be higher than the liquidation price that rests on the preferred shares of the venture capital.[61] When the company goes into liquidation procedure, the venture capital will have a priority to other shareholders to getting back their purchase price plus the value agreed on in the liquidation preference clause. Thus the liquidation preference protects the venture capital to an overvalued purchase price by the entrepreneur. A liquidation preference, in another way, helps the venture capital screen for entrepreneurs who are confident of their own abilities and committed to their venture.[62] Otherwise they would never accept a liquidation preference with a multiple of the original purchase price.

Next to this, venture capitalists use preferred stock with a liquidation preference for another reason. It gives the entrepreneur an extra incentive to increase the value of the company.[63] If the start-up performs poorly, the entrepreneur will get less than her pro rata share of the start-up's value, and nothing at all if the start-up's value is less than the liquidation

[59] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 116

[60] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations* (2003) p.34

[61] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 116

[62] W. Sahlmann, 'The Structure and Governance of Venture-Capital Organizations', *Journal of Financial Economics* (1990), Vol. 27, Issue 2, p.473-521

[63] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 117

preference.[64] This is because the liquidation preference gives preferred shareholders priority to the common shareholders in the event of any liquidation. But when the start-up does well and the venture capital will converts its preferred into common, the entrepreneur will receive her pro rata share of the company's value.

As we have seen above, the preferred shareholders acquire power over the other participants in the start-up. These control rights consists of protective provisions in the shape of specific veto rights which gives the venture capital the power to approve certain transactions.[65] To such transactions one should think about significant transactions such as the sale of the most important assets of the company.

Another way to control the start-up is the use of staged financing. Staged financing gives the venture capital the ability to stop financing when certain milestones are not met by the start-up. Staged financing gives the venture capital substantial influence over corporate decision making.[66] Next to controlling the start-up, staged financing also works as an incentive for the entrepreneur to perform. When the start-up achieves the milestones set by the venture capital, the next investment will only be done when this mile stone is met. When the entrepreneur does not perform he will not receive the next amount of investment and this means the start-up is not developing. Also the venture capital is reducing its risk with staged financing, when it is becoming clear that the start-up is not developing in the way the venture capital desires, the venture capital can stop the investment temporarily and take measures in order to make sure the milestones can be reached. Such a measure can be the replacement of the management of the start-up, if the entrepreneur-manager is not performing as the venture capital requires the venture capital has the power to replace the entrepreneur with a professional manager. [67] The venture capital have the power to replace the manager due to the fact the preferred stock gives them board control.

Board control is another way of the venture capital to acquire control over the start-up. Board control gives them the possibility to manage and control the board of directors. Where veto rights and staged-financing only protects the venture capital for transactions which have

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[64] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 116

[65] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 119

[66] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 120

[67] W. W. Bratton, 'Venture Capital on the Downside: Preferred Stock and Corporate Control', *Michigan Law Review,* (2002) Vol.100, No. 5. p. 894-95 &; J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 122

negative influence on them.[68] Board control gives the venture capital the power to manage the start-up and by this way they can initiate fundamental transaction such as mergers, IPO's and liquidations.[69] The venture capital acquires board control by appointing independent directors who take a seat in the board of directors of the start-up. These independent directors are often not that independent as their designation suggests. Because they get appointed by the venture capital, they have an incentive to side with the venture capital and besides if they perform well, they can expect a long-term professional and business relation with the venture capital, who can appoint the independent director for board seats in other venture backed start-ups.[70] The independent directors support the board of the start-up with experience, knowledge and useful contacts, as the entrepreneur is inexperienced, this can be of great value to the start-up.

Another important reason for appointing independent directors to the board of the start-up is that due to board control, the venture capital can monitor the management and thereby their investment. Often the goals of the entrepreneur differ from those of the venture capital, as the entrepreneur aims at continuation and the development of the business and the venture capital seek the highest possible return on investment.[71] These agency costs always occur when parties enter into an agreement but have different goals. The entrepreneur can have a different view for the use of the investment of the venture capital than the venture capital itself. For example, the entrepreneurs can assign themselves extensive salary or private benefits instead of putting the money where it is necessary in order for the business to grow. By board control the venture capital can avoid these problems, they have influence and a vision on how their investment is used. As we have seen above, the venture capital can also replace the entrepreneur-manager with a professional manger due to board control, if the entrepreneur is not performing as the venture capital requires.

When venture capitalists invest in start-up through preferred stock an unusual corporate governance structure occurs. As we have seen different agency costs arise because of the venture capital investment in preferred stock. The extensive control rights and powers they acquire with preferred stock are a mechanism to control their investment and in a certain way

[68] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 120
[69] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 120
[70] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 121
[71] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 122

control the start-up.[72] These control rights are obtained by the term sheet parties agree on. In the chapter 5 we will discuss the term sheet of both the business angels and the venture capital.

3.3 The Venture Capital Exit

A venture capital provides capital to start-ups and guide start-ups to become a matured and profitable company. This in the interest of the entrepreneurs, who want to have a successful business and logically also in the interest investors who have contributed to the start-up. The venture capital, who often provides the biggest amount of capital to the start-up, would like to see the start-up mature in several years.[73] After this period, the venture capital wants to have a return on investment. The success of venture capital depends on the ability of venture capitalists to exit their investments by taking the start-ups they fund public (initial public offering or IPO) or selling them to another company (acquisition or trade sale).[74] An initial public offering means that the shares of the company will be offered to the public on a securities exchange. This means everybody can now buy the shares from the venture capital and by this way the venture capital get its return on investment. When the start-up is acquired by another company it is called an acquisition or trade-sale, the acquirer buys the shares of the target company (in this case the start-up). By this way the venture capital receives a return on its investment. Basically these are the only two ways the venture capital can exit the investment and get a return on invest. But nowadays there is a third option for a venture capital to exit their investments; the secondary market which will be discussed in 3.2.3 below.

Venture capitalists who are investing in start-ups have a certain time scheme in which they want their return on investment. By going public or acquisition, they will receive a return on investment. This is why venture capitalists will put pressure on the start-up to exit their investment. As we have seen before, when venture capitalists invest they receive preferred shares which gives them extensive control rights and power over the start-up company. These

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[72] Fred Wilson, *Entrepreneurs Have Control When Things Work, VC's Have Control When They Don't*, avc.com Jul 25 2012. Available at <http://www.avc.com/a_vc/2012/07/entrepreneurs-have-control-when-things-work-vcs-have-control-when-things-dont-work.html >. On his blog, Fred Wilson explains that the actual control over the start-up in practice depends on the performance of the entrepreneurs. When the entrepreneurs are doing a good job, the VC can leave control to them. But when entrepreneurs are underperforming a VC will not hesitate to take control. Berry, Tim, '*Control Depends More On Result Than Term Sheets*', Blog: 'Thoughts on Start-ups by Investors that Fund Them & Entrepreneurs that Run Them.' Gust.com Jul 25 2012. Available at <https://gust.com/angel-investing/startup-blogs/2012/07/25/control-depends-more-on-results-than-term-sheets/ > Berry explains that the statement Fred Wilson made on his blog is indeed true and that control depends more on the performance of the start-up than on the term sheet investors and start-ups agreed upon.

[73] Thomas Reuters, '*National Venture Capital Association Yearbook 2012*' (2012) p.7

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

control rights reduces the agency costs for the venture capital, as they are now in control instead of the entrepreneurs and other investors. But also this creates new agency costs for entrepreneurs, as they are now vulnerable to venture capital opportunism. [75] The venture capital has a liquidation preference, which means that a liquidity event such as an IPO will be a payout for the venture capital. This leads to venture capitalists putting pressure on the start-up to exit their investment, so the venture capital receives a return on investment. But this brings the risk that the start-up is yet not matured enough. Venture capitalists can do so, due to their controlling position acquired by investing in preferred shares. Business angels are likely to be more patient, when it comes to exit their investments. This can be due to the fact they do not have the power and are more aligned with the interest of the entrepreneurs.

When the board of directors is not firmly under control of either common or preferred shareholders, conflicts of interest between founders, angels and venture capitalists arise.[76] The venture capital has a liquidation preference in a certain time frame. Angels would like to see a return on investment as well, but their main goal is helping the start-up to develop to become a mature business and entrepreneurs want their business to be successful and continue it. When these three parties together are in control of the start-up, the conflicts of interest between parties seem to affect the performance of the start-up. Mixed control can be more easily influenced by various parties, and hence conflicts of interest are more likely to shape firm decisions and thus outcomes.[77] Research has shown that when the venture capital is the only investor, the deals are more successful than those in which business angels participate, this due to the fact that the venture capital is in control and conflicts of interest are less likely to arise.[78]

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[75] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 101

[76] Hoberg, & Others, '*Does Angel Participation Matter? An Analysis of Early Venture Financing*', (March 15, 2012) p.4

[77] Hoberg, & Others, '*Does Angel Participation Matter? An Analysis of Early Venture Financing*', (March 15, 2012) p. 23-24

[78] Hoberg, & Others, '*Does Angel Participation Matter? An Analysis of Early Venture Financing*', (March 15, 2012) p.4

3.3.1 Initial Public offering

Initial public offerings give the public the possibility to buy shares of a company on a securities exchange. The public can buy the shares from the investors, and the investors in their turn, get a return on investment. An IPO has been the most successful exit in the United States for venture backed start-ups for years; it was the gold standard for venture capital success.[79] In the late 1990's hundreds of IPO's took place of venture backed start-ups with up to 42 times return on investment for venture capitalists.[80] But nowadays that number dropped to a desolate of only 6 in 2008, 12 in 2009 and recovered slightly to 53 in 2011.[81] Also the time to IPO increases from 3 to 6 years between 2000 and 2004 compared 6 to 9 years between 2008 and 2011.[82] Although these drops can be partially attributed to the financial crisis that we have to endure, even the year 2005 till 2007 when the economy was at large, there were yearly less than 100 IPO's. This is not even close to the hundreds of IPO's in the late 90's.

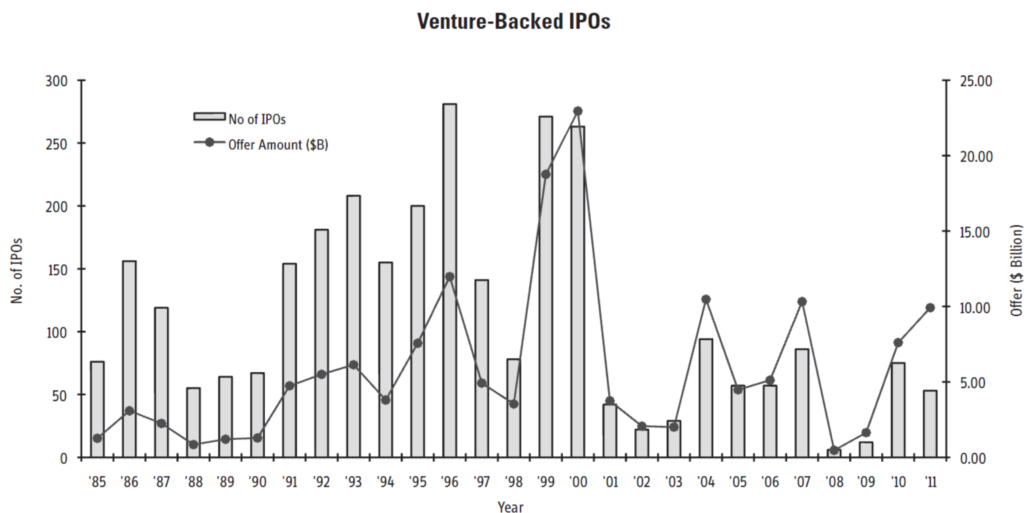

Figure 4
Initial Public Offerings of venture-backed start-ups by year 1985-2011

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

[80] A. Metrick, Venture Capital and the Finance of Innovation 89 (2007) & D.M. Ibrahim, 'The New Exit in Venture Capital (2010)', *Vanderbilt Law Review*, Vol. 65, 2012; p. 102

[81] Thomas Reuters, '*National Venture Capital Association Yearbook 2012'* (2012) p. 51

[82] E.P.M. Vermeulen handouts lecture 10 of International Business Law I at Tilburg University (spring 2011)

3.3.2 Acquisition

Next to going public, acquisition (M&A) is another way for the venture capital to exit its investment. This means the start-up is purchased by another company, called the acquirer. The investor sells its shares and receives a return on investment. In 2011, the number of acquisitions raise to 458 which was an increase over 442 in 2010.[83] As we can see in figure 5, the number of acquisition is steadily growing. This in contrast to the number of IPO's which are unsteady and dropping (Figure 4).

Venture-Backed
Merger & Acquisitions by Year

	Number	Number	($ Millions)	
Year	Total	Known	Price	Average
1985	6	3	271.2	90.4
1986	10	1	86.8	86.8
1987	13	4	398.1	99.5
1988	16	6	481.1	80.2
1989	18	5	371.8	74.4
1990	19	8	131.8	16.5
1991	18	5	221.5	44.3
1992	75	46	2,344.8	51.0
1993	70	42	1,656.0	39.4
1994	98	61	3,383.0	55.5
1995	97	60	3,788.3	63.1
1996	119	77	8,531.0	110.8
1997	161	114	6,937.8	60.9
1998	212	132	9,459.4	71.7
1999	237	162	37,641.0	232.4
2000	317	205	68,029.9	331.9
2001	351	163	17,655.0	108.3
2002	323	152	7,467.9	49.1
2003	283	118	7,405.2	62.8
2004	345	182	15,376.9	84.5
2005	351	159	17,081.2	107.4
2006	377	167	19,337.4	115.8
2007	376	170	27,973.1	164.5
2008	351	120	13,769.2	114.7
2009	274	91	11,610.2	127.6
2010	442	128	18,382.5	143.6
2011	458	164	24,072.1	146.8

Average acquisition price is calculated by dividing total known acquisition proceeds by the number of transactions where the proceeds are known, not the total number of transactions.

Figure 5
Venture-Backed Mergers & Acquisitions by year 1985-2011

3.3.3 A new exit in venture capital financing, The Secondary Market

Since the exit markets nowadays are poor, a new third exit option arises; the secondary market. The secondary market is the market where individual investors in start-ups and venture capital

[83] Thomas Reuters, '*National Venture Capital Association Yearbook 2012*' (2012) p. 55

funds can sell their ownership interest even before a start-up has its own exit event.[84] With other words, the investor decides for itself when to exit the investment in the start-up by selling its ownership to a third investor.

The secondary market takes place on an individual investor level instead of the start-up level.[85] This means the investors decides for itself when he exits the investment and not the start-up by which an investor can only exit via an IPO or acquisition. Investors can exit whenever they need the capital, for example when a venture capital fund is about to expire and must return capital to its investors. Due to a secondary market, the venture capital fund that is in need for capital does not need to put pressure on the start-up to exit but they can exit the investment itself.[86] This also leads to more efficient outcomes for the start-up, which will no longer be forced into premature traditional exits to satisfy a venture capital liquidity needs.[87] This means the agency costs that arise between entrepreneurs and venture capitalists in traditional exits that we have discussed above will cease to exist with the presence of the secondary market.

When investors invest in a start-up they contribute capital. This capital can be '*locked-in'* into the start-up, which means that investors are not free to withdraw their capital from the entity once they have contributed it.[88] The capital contributed is part of the start-up unless they will be dissolved. Capital lock-in can be beneficial to a start-up because it attracts other investors, managers and employees because it assures them those investors cannot withdraw their contributed capital and therefore have any influence in the start-ups stability. But on the downside capital lock-in increases agency costs due to the fact that it eliminates the threat of capital withdrawal which is an important mechanism to discipline the start-up's managers.[89]

Next to capital lock-in, there is a more severe situation called *'investor lock-in'.* This means that not only the capital is locked-in the start-up but so are the investors. In this situation there is the absence of a market where an investor can sell its ownership to a third party.[90] Investors lock-in increases capital costs due to the fact that it will be harder to find investors if they are locked-in to a start-up. Also it leads to governance problems within the start-up, just like

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[84] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 116
[85] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 103
[86] J.M. Mendoza & E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p.3. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >
[87] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 103
[88] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 106
[89] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 106
[90] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 107

with capital lock-in investor lock-in eliminates the threat of withdrawal which means an important mechanism to monitor mangers is absent.[91]

In the case of a venture capital investment, there are two levels on which the capital can be locked-in. First on the upper level of the venture capital fund, where the limited partners invest in a venture capital managed by general partners and are not allowed to withdraw their investment from the venture capital fund. The capital is locked-in for the lifetime of the fund which can be ten to twelve years.[92] On the bottom level, the venture capital which invests in preferred shares are not allowed to withdraw its investment by corporate law. This bottom level of venture capital funds is referred to in the industry as the ‘secondary direct’ market or ‘direct’ market. This leads to capital lock in, although often the venture capital is including redemption rights in their term sheet, so they can redeem at will.[93]

Investor lock-in in venture capital investment is a problem in the case of a weak traditional exit market.[94] As mentioned before, IPO is the golden standard in venture capital financing. When there is no perspective on a successful exit, the secondary market can be the solution for venture capital success. Without the perspective of a successful exit, the venture capital hands are tight due to investor lock-in. But with the presence of the secondary market, a new pad to liquidity is offered.[95]

3.3.4 Benefits of the secondary market for venture capital funds

The introduction of the secondary direct market goes along with important benefits. The most important benefit of the direct market for venture capital investments is the improved liquidity.[96] This is especially of importance when the traditional exit markets are weak so investors can divert to the secondary direct market.[97] Both investors and start-ups benefit from the secondary direct market. First investors who are willing to sell their shares, they will find that locating potential buyers is easier on the secondary direct market because this information is now public.

[91] D.M. Ibrahim, ‘The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 108

[92] Thomas Reuters, ‘*National Venture Capital Association Yearbook 2012*’, p. 15

[93] D.M. Ibrahim, ‘The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 110. We will discuss redemption rights in the term sheet in the next chapter.

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

[95] J.M. Mendoza & E.P.M. Vermeulen, ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p.3 Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 > & D.M. Ibrahim, ‘The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 151

[96] [96] J.M. Mendoza & E.P.M. Vermeulen, ‘The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p.3. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

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

Start-up benefits from the secondary market due to the fact it creates the possibility that more start-ups will be financed by venture capital funds.[98]

But maybe more important benefits of the secondary direct market in the context of this thesis are the improved governance of the start-up investments. The agency costs in start-up investment are high due to allocated control rights. When entrepreneurs are in control of the start-up, the venture capital is vulnerable to entrepreneurial opportunism. [99] This problem is solved by the venture capital by requiring preferred shares instead of common shares. These preferred shares gives the venture capital extended control rights to protect their investment. But this also creates new agency costs; the entrepreneurs are now vulnerable to venture capital opportunism.[100] As a conclusion we can say that it does not matter where the control is allocated, agency costs will always occur in this start-up structure. But with the introduction of the secondary market, these agency costs in start-ups can be reduced.

Before the secondary direct market, the law tried to reduce the agency costs with fiduciary duties. But as we have discussed before, fiduciary duties are not effective in reducing the agency costs. Due to the fact that venture capital invest in preferred shares which brings only contractual rights and fiduciary duties have only effect on common shareholders.[101] Other constraints to reduce agency costs in start-ups such as shareholder voting and the nomination of independent directors prove to be far from perfect.[102] Now it seems that the secondary direct market can reduce the agency costs that arise in venture capital financing of start-ups. Firstly, venture capital's role in start-ups is an active one; they monitor and control the start-up. With the introduction of the secondary direct market, the venture capital can threat to exit the investment if they are not satisfied with the performance it delivers. This gives the start-up the incentive to perform. This also works the other way around; entrepreneurs have the opportunity to exit their start-up when the venture capital which invested is poorly performing. By this way both parties are in a better position to observe each other's performance and threaten to exit as a result.[103] Both parties understand that they need each other to make this start-up a success, when one of the parties exits this will have negative consequences. Secondly, with the introduction of the

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

[99] J. A. McCahery & E. P. M. Vermeulen, 'Limited Partnership Reform in the United Kingdom: A competitive, Venture Capital Oriented Business Form, *Tilburg Law and Economics Center Discussion Paper,* No. 2004-024p. 15. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=664166>

[100] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006)*,* Vol. 18, p. 101

[101] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006)*,* Vol. 18, p. 109

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

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

secondary direct market the vulnerability of one party against the other, who is in control, disappears. Without the secondary direct market one party can be in control and this leaves the other vulnerable. When a party has the possibility to exit the project, he has a certain power to control the other party. This means with a secondary direct market, it does not matter where the control is allocated.[104] Entrepreneurs and venture capitalists both have the power to exit when one of them is suffering from high agency costs. So both parties have the same power regardless which one has the actual control of the start-up.

Also, by giving parties the possibility to sell their shares on the secondary direct market it reduces transaction costs that otherwise would be incurred in ineffective litigation.[105] Dissatisfied shareholders can now go and sell their shares on the direct market instead of spending money and time on expensive litigation.[106]

Another important benefit in the content of this thesis is that the secondary direct market mitigates conflicts between venture capitalists and entrepreneurs over traditional exits. As we have seen before, without the secondary market, venture capitalists have the tendency to push the start-up to a traditional liquidation. Venture capital controlled boards may prematurely push for liquidation events that hurt common shareholders more than they benefit the preferred, thereby reducing total shareholder value.[107] Now with a secondary direct market, there is no need to push the start-up to liquidation. The venture capital can just sell it shares on the secondary direct market if they need to exit the investment. On traditional exits, going public is mostly not the problem for entrepreneurs and venture capitalists. This due to the fact that through an IPO the venture capital receives higher returns on investments and the entrepreneurs will receive the control of the start-up back in their hands.[108] But the more problematic one of traditional exits are the acquisitions. By acquisition, the venture capital will receive a return on investment but the entrepreneur will not receive control back. Control will be allocated to the acquirer and as the venture capital has a liquidation preference most of the time other shareholders will not even see a return on investment if the amount that is involved with the acquisition is not high enough.[109] The secondary direct market mitigates these problems over traditional exits because shareholders have the option to exit whenever the incentives of

[104] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 129
[105] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 130
[106] The *Equity- Linked* and *Orban* cases have proven that seeking a fiduciary remedy in court has a low probability of success.
[107] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 129
[108] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 130
[109] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 132

the parties involved are not aligned. Not only at the individual investor level but also at the start-up level, the secondary market leads to a more efficient outcome. All current investors will be focused on long-term value creation, as opposed to traditional market situation, where one of the parties liquidity needs could put pressure on the start-up to exit prematurely. [110]

The secondary direct market offers benefits such as increased liquidity, improving start-up governance and mitigates agency costs. But next to these advantages the secondary direct market can also have a disadvantage. By having the opportunity to exit the start-up for both investors and entrepreneurs, the incentive to maximize performance is decreasing.[111] When there is no possibility to exit except the traditional exits, the incentive to perform is stimulated to maximize the success. When one can exit whenever they want, the incentive to monitor and stimulate to perform will disappear. But these drawbacks of the secondary direct market can be mitigated as well, for example by selling only partial shares.[112]

As a conclusion we can say that the introduction of the secondary direct market brings important benefits to the governance structure of venture backed start-ups. It is a new and important tool to mitigate agency costs in the start-up and mitigate conflicts about traditional exits.

[110] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; 132
[111] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012;; p. 134
[112] D.M. Ibrahim, 'The New Exit in Venture Capital (2010). *Vanderbilt Law Review*, Vol. 65, 2012; p. 134

4. The Term Sheet

When entrepreneurs have successfully find a business angel or venture capital who is willing to invest in their business, the investment terms has to be defined and agreed upon between parties. The proposed terms for investment are outlined and agreed upon in the investment term sheet. The investment term sheet has two functions, first it summarizes all the important financial and legal terms related to the proposed transaction and second it quantifies, both in numbers and qualified terms, the value of the transaction.[113] Both business angels and venture capitalists use these term sheets to outline their terms for their investment before they enter into an investment deal. The term sheet is the most important document between the start-up and the investors, it establish the framework for the interaction and the company governance and has a significant impact on the entire start-up.[114] Wilmerding states that 'The value of a term sheet is its ability to focus parties in a deal on the essence of the deal prior to initiating costly legal drafting and to move them to close the transaction.[115] Parties keep the term sheet relatively short so they do not spend excessive time in this early stage of the investment, the benefits of using the term sheet are that it highlights key issues which require the focus of both parties and also provide a 'moral commitment' on both sides to observe the terms agreed in future negotiations.[116] The term sheet is drafted by the initial investors and presented to the company, then the term sheet will be subject to negotiations and when parties finally agree, the term sheet will be signed.

Because all entrepreneurs are different, all start-ups are different and all investors are different, all investments are different. What one entrepreneur requires does not have to be a requirement of another entrepreneur, and this is the same for investors. That is why there is not one basic term sheet. Not only the requirements of the investors and the entrepreneurs are affecting the term sheet, also the profile of the company and the investment climate at the time of the investment have influence on the term sheet. It is the context what dictates the contents of the term sheet.[117] Often the provisions of the term sheet are the same, but how these provisions are to be filled in always differ. The terms and conditions on investments differ

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

[114] Basil Peters, 'The evolution of the Term sheet part 1 a Seminar for Bellingham Angel Group' November 17 2009. *Exits.com* available at <http://www.exits.com/blog/angel-term-sheet-evolution-part-1>

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

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

[117] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations'* (2003) p. 12-13

according to the context of the investment.

The provisions of the term sheet are technically not legally binding.[118] With the exception of some provisions which are legally binding such as those dealing with confidentiality, exclusivity, costs and professional fees.[119] The term sheet gives parties an implied duty to negotiate in good faith, it reflects an agreement between two parties to proceed to a financing subject to the terms incorporated in the term sheet.[120] Also as mentioned before the term sheet gives parties a 'moral commitment' to observe the terms agreed in future negotiations.[121] In this chapter I will explain which provisions can occur in an investment term sheet.

4.1 Provisions of the Term Sheet

Each term sheet contains different provisions and even the content of every provision is different from other term sheets. But next to these differences there are certain sections in term sheets that occur in every term sheet. These sections are 'the preamble', 'the opening information', 'the offered terms', 'the shareholders rights agreement' and 'other matters'.[122] Each section and its provision will be discussed below. Nowadays mostly all investments in high-tech start-ups are done by using preferred shares. Also angels more often use preferred shares, therefore we will discuss the term sheet of preferred shares.[123]

4.1.1 The Preamble

The preamble of the term sheet contains a time or period for which the term sheet will be in place, also the preamble can contain a provision that limits the ability of the entrepreneur to look for other investors.[124] Next to this, the preamble can contain a lock-up period. This means that

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[118] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations'* (2003) p. 9 - The British Business Angels Association and Evershedds LLP, 'Improving The Investment Process: The Standard Legal Documents And How to Use Them p. 12 (2008) & The British Venture Capital Association: ' A guide to Venture Capital Term Sheets' (2004) p.4

[119] The British Business Angels Association and Evershedds LLP, 'Improving The Investment Process: The Standard Legal Documents And How to Use Them p. 12 (2008) & The British Venture Capital Association: ' A guide to Venture Capital Term Sheets' (2004) p.4

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

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

[122] In some Term Sheets, the section 'Employee Matters' occur as well

[123] As we will discuss below, angel groups are using a venture capital like term sheet and therefore preferred shares

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

anyone within the company cannot inform or discuss another term sheet with third parties without prior written consent to the investors.

4.1.2 Opening Information

The opening information of the term sheet gives a summary of the proposed deal, what company receives the investment, who is investing, what amount, and what kind of shares are acquired. The opening information gives a good overview of the deal and it clarifies the nature of the transaction, especially for people who are not close to the transaction. [125] Often the opening information is not included in the term sheet, instead of the opening information the title of the term sheet will summarize the parties in the deal and the shares that are issued with the amount of investment.

4.1.3 The Offered Terms

What is written down in the offered terms already appears from the name of the section; the terms that are offered from the investor. The section lists information such as the amount that is invested, who the issuer and the investor are, the number of shares issued, what type of securities are issued, the price per share, the pre-money and post-money valuation and the closing date. This is the core of the term sheet and most information will explain itself.

4.1.3.1 Amount, Issuer, Investor, Number of Shares & Closing Date

The amount invested is the total money the investor is investing in the company. The issuer is the one who is receiving the investment and therefore selling shares to the investor. The investor is obviously the one that is providing the money to buy the shares from the issuer. The numbers of shares issued are the number of shares the investor receives resulting from its investment. The closing date is the date on which the deal is closing, the offer stands till the initiated closing date.

4.1.3.2 Type of Security

The provisions above were easy to understand facts of the investment. But when we come to the type of securities that are issued, some more attention is required. It is important for entrepreneurs to understand what classes of securities can be issued and what each class of shares means for their company. Investors can choose to invest in common shares; this type of

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

class brings one vote per share in case a shareholder vote is called but no additional special powers.[126] When entrepreneurs, friends and family invest in the company they obtain common shares. Next to common shares, angels can invest in convertible debt. The convertible debt is a bridge loan that converts into equity in the next equity round, these convertible debt securities enable the next round of investors to set the value of the company in the later round.[127] Also, the company can issue preferred shares. Preferred shares give the owners substantial powers compared to the owners of common shares, by this way the owners have an influence on the performance of the company. Preferred shares create control rights that give owners the possibility to control and monitor their investment.[128] Also, a liquidation preference is attached to the preferred shares that create a claim for preferred shareholder to cashflows, prior to the common shareholders. Next to this, preferred shares will be rated more valuable, and in turn common shares will receive a lower valuation, which can be a tax advantage.[129] Often preferred shares are convertible into common shares, this means that within a certain time frame or due to a liquidation, the preferred shared can convert to common shares. These issues concerning the type of shares have to be issued are of most important to the company and therefore need a closer look by the entrepreneurs. Because nowadays mostly all investments in high-tech start-ups are done by using preferred shares. Also business angels more often use preferred shares, therefore we will discuss the term sheet of preferred shares and not common shares.

4.1.3.3 Price per Share, Pre-Money and Post-Money Valuation

Other important terms of the term sheet are the price per share, the pre-money valuation and the post-money valuation. The price per share is determined by the pre- money valuation because the pre-money valuation is the value of the company today (without the investment offered by the term sheet). The post-money valuation is the value of the company after the investment. The difference between the post-money and pre-money valuation is the amount of the investment that is proposed in the term sheet. The post-money valuation will summarize what the capital structure of the company will look like after the proposed financing.[130] The price per share will explain itself; it is the purchase price per share that is proposed in the investment.

[126] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 32
[127] MIT Entrepreneurship Center, 'Venture Support Systems Project: Angel Investors' 28 (2000) p. 38
[128] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 129
[129] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1414
[130] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 37

The purchase price per share is calculated by dividing the pre-money valuation by the fully diluted number of shares of the company immediately prior to the time of completion.[131]

There are two other items which should be taken into account; stock option pools and warrants. Option pools are a way to attract talented employees to the company. When the company is doing well and goes public, the employees will be compensated with the stock of the option pool. The size of the pool is taken into account when the pre-money valuation of the investment is done. A large option pool is lowering the pre-money valuation, which will result in a decrease of price per share.

Warrants are an incentive to invest, the company allows the holder the right to purchase the securities at a certain price within a certain time frame. The difference between options and warrants is that options are not issued by the company and are exchange instruments whereas warrants are issued and guaranteed by the company.

4.1.4 The Terms of the Preferred Shares

In this section the terms of the shares that are bought by the investors is explained. What the terms of the shares are depends on what type of security the investors have invested in. The section contains terms such as the terms on the dividends, liquidation preference (only for the preferred shares), the conversion of shares, anti-dilution protection, voting rights, redemption and protective provisions.

4.1.4.1 Dividend rights

Dividend rights is a protective provision that gives the investors the right to get a return on investment. Although the main goal of a start-up is to develop to a mature company, dividends allow investors to protect their investment and get out of an investment with at least some prospect of a return in case of a liquidity event.[132] The amount of dividend paid upon shares is a fixed percentage of the purchase price and the provision also explains in what time frame the dividends will be disbursed. Most often this will be annually. Some start-ups want to reinvest every profit they make in order to continue growing. These companies can prohibit paying dividends to shareholders for a limited period of time. Another way for start-ups to reinvest profits to grow their businesses is by issuing not just preferred shares but issuing preferred shares with cumulative dividends. Cumulated dividends enable the start-up to cumulate any

[131] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 8
[132] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations'* (2003) p. 40

amounts of dividends not paid until the start-up has the available cash.[133] When the start-up is able to payout any dividends, due to their class of securities the preferred shareholders will receive these dividends prior to ordinary shareholders. In addition, preferred shareholders often require that any dividend paid to the common shareholders will be paid to the preferred shareholders pro rata.[134] This in order to prevent that start-ups will declare a small amount of dividend to preferred shareholders and a larger amount of dividend to the common shareholders.

4.1.4.2 Liquidation preference

One of the most important provisions of the term sheet for investors in preferred shares is the liquidation preference. The liquidation preferences has been explained before and means that when one invests in preferred shares, the preferred shareholder has a additional rights and one of these rights is the preference on cash flow to other shareholders in case of any liquidation.[135] In other words, the preferred shareholders will receive their money prior to other shareholders. Liquidation of the start-up in which is invested in does not have to be devastating for the investor. Because the liquidation preference can contain a multiple on the value of the initial investment, investor can receive a higher amount in return than their initial investment. This can be a multiple of one to even three in the most risky investment with investor favorable terms. Start-ups best obtain for the return of the initial investment and a pro rata distribution of the remaining assets with the ordinary shareholders. The rationale of the liquidation preference is that it is a way to protect preferred shareholders of the risk they are taking when investing in start-ups.

4.1.4.3 Conversion & Automatic Conversion

The conversion provision is a control provision that states that preferred shareholders can converse their preferred shares to ordinary common shares at any time and generally to a one-to-one conversion ratio. The reason for obtaining a conversion clause is to enable preferred shareholders to convert their preferred shares to common in the event of a liquidity event that is likely to generate a return that is higher than the multiple return on investment deriving from the 'liquidation preference' provision.[136] Another less occurring reason for conversion to common

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[133] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations'* (2003) p. 40 & The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' p. 9 (2004)

[134] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 10

[135] Liquidation can be winding-up or bankruptcy but also an exit such as acquisition, merger or an IPO.

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

shares is in the case of exercising a vote about a specific issue, which is only obtained with common shares. But once converted to common shares, the shares cannot be converted back into preferred.

More interesting is the automatic conversion provision. This provision describes what happens to the preferred shares when a company goes public. There are certain variables in this provision that can be subject in discussion in negotiations when automatic conversion is triggered, such as a minimal amount of money involved in the public offering and the multiple price per share of the original purchase price.[137] Also which exchange market and which underwriters can facilitate the initial public offering can be incorporated in the provision. These variables will protect the preferred shareholder against a weak public offering which can be pushed by the other shareholders.

4.1.4.4 Voting Rights

Preferred shareholders will have control rights attached to their class of shares. One of these rights is voting rights. The voting rights provision states that when a shareholder vote is called, the preferred shares and common shares are treated equally.[138] Other rights that are attached to the preferred shares are explained in the 'protective provision' section below, the voting rights are important to preferred shareholders but they are supplemented by additional powers from the 'protective provision'.[139]

4.1.4.5 Protective Provisions

When the company wants to make certain decisions, the protective provision explains to what decisions they need to consent the majority of the preferred shareholders. This provision protects the preferred shareholders from the company taking actions which may adversely affect the value of their investment.[140] Typical actions that need the consent of the preferred will be actions that can cause major changes in the start-up. Actions of the company can be, the issue of new shares (which can have a diluted effect on the series A preferred shareholders), changes to existing type of shares and share rights, mergers and acquisitions, the sale of major assets, changes to the capital structure, winding up or liquidation of the company, declaring dividends, changes in the board structure, a reorganization and any other major changes that

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[137] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 48

[138] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 17

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

[140] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 18

can affect the preferred shareholders. The protective provision can be of particularly important to preferred shareholders who do not appoint a director to the board of directors (which will be discussed in the 'Board of Directors' provision).[141]

4.1.4.6 Anti-Dilution Provision

The anti-dilution provisions is a protective provision. This provision takes into account what happens to the value of the shares of the existing shareholders when there is a new round of financing as the company starts to grow.[142] When a new round of financing takes place; new shares will be issued at a certain price. When these new shares will be sold for a price which is lower than what the existing shareholders paid in prior rounds, this will dilutes the shares of the existing shareholders. When the prices of the future rounds of financing will be below the previous round, it is called a *down round*. When the prices of the future round are equal to the previous round, it is called a *flat round*. Usually the diluted effect on existing shares is calculated by a mathematical formula. Every different formula offers a different degree of protection. A *full ratchet* protection means that the investors maintain the full percentage of ownership at the same level or at the same value in down rounds.[143] The *weighted average* protection provides investors compensation for the dilution, but allows the ownership percentage to fall. Anti-dilution provisions are almost always part of the terms of an investment.

4.1.4.7 Redemption

Redemption clauses ensure that the start-ups are not just doing business to give its founders and management a salary but that the start-up will grow and generate liquidity.[144] Most investments have a time frame of a number of years, which will be determined in the redemption clause. The redemption cause regulates that when after a certain number of years, if the start-up did not generated any liquidity, the start-up will be obligated to redeem the investor's interest in a certain period of time.[145] Liquidity can be generated by an initial public offering, acquisition and even a buy-out that allows the interest of investors to be purchased. Basically this clause

[141] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 18
[142] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 56
[143] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' p. 13 (2004)
[144] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 44
[145] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 45

protects the investor when the start-up is not performing, the start-up has to buy back its shares from the investors when there is not been an exit in a pre-determined period.[146]

4.1.5 Shareholders Rights

In this section of the term sheet the rights of the shareholders are assigned and explained which investors obtain when they invest in a company. Rights of shareholders can be provisions on the board composition, special items to which the board has to give permission, the right to gain information from the start-up and others as explained below.

4.1.5.1 Board Composition

In the board composition clause, which is a control provision, the board of directors is composed with the influence of the investors. The proposed board composition in the term sheet is often of big influence on the existing board of directors, also depending on the investor; business angel, angel group or venture capital. As we will discuss later on, business angels may not even want to be involved with the board or the business angel will participate itself. Angel groups and venture capitalists, which are more involved with big amount of investments, would want to participate in a higher degree in the board of directors. By electing one or more directors they are protecting their investments so they can have influence on the decision taking of the board.[147] Boards can exist of five members, because this is an arbitrary number but this can be adjusted to the circumstances. The goal for electing directors is provide excellence guidance to the entrepreneur and support him with the knowledge of the investor.

All directors must act in the interest of the company to avoid conflicts of interest, the investors can appoint a neutral independent director to take the position in the board. Because investors are acting more in the interest of the fund, instead of the start-up. As discussed above, the independent director will often not be that independent in practice. Due to the fact that they are appointed by the investor, they have an incentive to side with the investor and act more in their interest than in the company's. In a situation that the investor made a good investment and independent director was part of this success, he can look forward to a more long-term professional relationship.[148]

Often the board will have a committee who will decide on the board's compensation or

[146] The British Venture Capital Association, ‘A Guide To Venture Capital Term Sheets’ (2004) p. 15
[147] The British Business Angels Association and Evershedds LLP, ‘Improving The Investment Process: The Standard Legal Documents And How to Use Them (2008) p. 14
[148] J. M. Fried & M. Ganor, ‘Agency Costs of Venture Capitalist in Startups’, New York University Law Review (2006), Vol. 18, p.121

remuneration and an audit committee to oversee the financial reporting. This to secure the objectivity, honesty and transparency of the board and the start-up company.

4.1.5.2 Special Board Approval Items

This provision, which is a control provision, is not always included in the term sheet, it depends if parties prefer this provision. Special board approval items are items on which the board has to give special approval before execution. Which items this can be is totally negotiable and depending on the investors and the start-up. One can think of appointing new officers, assumption of debt above a certain level, real estate leases or purchases and approval of financial and business plans.

4.1.5.3 Information Rights & Inspection Rights

The information rights provision is a protective provision which gives the investors access to the information in the start-up. This can be access to the annual or quarterly audited financial statement. But also access to unaudited monthly financial statements or even access to any document within the start-up. In order to monitor the investment, the start-up has to provide the investor whit certain regular updates concerning its financial condition and budgets, as well as a general right to visit the start-up and examine its books and records.[149] The extent to which entrepreneurs push back on the language proposed in Information Rights provision will reveal the extent to which they may be control-oriented by nature or have something to hide.[150] From the investors perspective it can depend to what extent he would like access to information of the start-up, if the investor has bad experience in the past he will require more access to information to monitor its investment.

4.1.5.4 Registration Rights

The Registration Rights provision is an exit provision necessary under the US securities law which is unknown for many European investors. In the US registration with the Securities and Exchange Commission (SEC) is necessary before it is possible to offer shares to the public in case of an initial public offering.[151] Registration process can be costly and very time consuming, registration provides information about its operations and financial situation of the start-up that is

[149] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 19
[150] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 62
[151] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 20

offering its shares to the public.[152] Next to the necessity to register before going public, the registration rights provision also stipulates the extent to which preferred versus common stock will share equal or preferential treatment when the preferred shares have been converted and are participating in a public offering.[153]

4.1.5.5 Rights of First Refusal

The Right of First Refusal acts as an exit provision as well and give the investor the influence over the sale of any other shares, also it gives investors the ability to buy the shares or restrict their sale. This implies that if there is a shareholder who wants to sell his shares which are subject to a right of first refusal to a third party, the shares must be offered first to the other shareholders who have the benefit of the right of first refusal.[154] As example, when shareholder A wants to sell its shares to a third party, shareholder B has the right to acquire the shares of shareholder A under the same proposed terms between shareholder A and the third party.

4.1.5.6 Drag Along Rights

The Drag Along Rights provision (sometimes called bring along rights, which are both exit provisions) creates the obligation on all shareholders of the start-up to sell their shares to a potential buyer, if the majority (or certain percentage) of the shareholders vote to do so.[155] For example, shareholder A (which is a majority shareholder) wants to sell its shares to a third party, shareholder A has the right to drag along shareholder B and to force shareholder B to sell its shares to the same conditions as shareholder A and the third party agreed upon. This provision makes it possible to deal with minor shareholder in the case of acquisition of the total amount of outstanding shares.

4.1.6 Employee Matters

The provisions discussed above are concerning the two main parties in the investment procedure, the start-up company and the investors. This section does not occur in every term sheet but it is important to discuss this section because certain provisions concerning the position of the investors towards the employees are regulated. The terms articulated in this section will typically outline the number of shares of common stock reserved for option pools and specific investing programs, co-sale agreements, whether key management insurance will

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[152] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 20

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

[154] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 15

[155] The British Venture Capital Association, 'A Guide To Venture Capital Term Sheets' (2004) p. 16

be provided for key employees, and any management hires that may transpire subsequent to the financing.[156] This section enables investors to regulate the powers of employees and founders with regard to their stock in the company.[157] The provisions in the employee matters will be briefly discussed below.

The *employee pool* determines the number of shares of common stock that is reserved for the founders of the start-up and additional future issuances to key employees.

The *Vesting* provision governs the fact that the common shares of the employees will not immediately be in the possession of the employees. First a particular time must have passed before the shares will be vested and in the possession of the employees. For example this can be, 20 percent to vest at the end of the first year and the remaining 80 percent to vest monthly over the subsequent four years. This makes it impossible for founders and employees to cash out their shares in early stage of the investment. Vesting gives employees and founders an incentive to perform and make the future value of their shares increase.[158] Also in the vesting provision it is regulated what happens to the shares if the employment of a shareholder is terminated. Most often, the start-up company is the one assigned to repurchase the unvested shares held by the shareholder. At last the vesting provision arranges what happens to the shares that are currently hold by the founders, most often it will vest under the same terms but with an extra credit because the founders already have put effort in the past of the start-up.

The *Restriction of Sales* provision will make sure the start-up company has the first right of refusal on all transfers of Common shares, subject to the normal exceptions. The right of first refusal gives the company the right to buy the shares from the selling shareholder before any third party can, also the company can restrict the sell.

The *Proprietary Information and Inventions Agreement* states that every employee of the start-up company shall enter into an acceptable proprietary information and invention agreement. This in order to protect the proprietary information and inventions of the start-up company, because often the ideas of the start-up are the most valuable assets to the company.

The *Co-Sale Agreement* is an agreement between the founders and the preferred shareholders. The agreement provides the preferred shareholders the opportunity to participate in the sale on a pro rata basis when the founders are willing to sell, exchange or transfer its

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[156] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 74

[157] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations*' (2003) p. 74

[158] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations* '(2003) p. 75

shares. The right on co-sale for the preferred shall terminate on the company's initial public offering.

The *Key-Man Insurance* provision gives the start-up company the obligation to enter into a insurance policy for important key-employee(s), with the company as beneficiary. This protects the company and the investors when something happens to a key-employee, which can have a negative effect on the start-up company.

4.1.7 Other Matters

Now we have discussed most of the provisions which a term sheet can contain. In this last part the last provisions which regulate the last formalities such as legal fees, expiration and governing law are explained. Also, a confidentiality and exclusivity clause are included in this section which will be discussed first due to their importance.

4.1.7.1 Exclusivity

The exclusivity clause prohibits the entrepreneurs for a certain period of time to look for other investors and to terminate negotiations with other investors.[159] Having spend money and time on due diligence, professional fees and negotiating the investment terms, investors will expect the entrepreneurs to demonstrate commitment to the process by terminating their negotiations with other investors.[160] Often when the entrepreneurs do want to discuss or negotiate with other investors, they first need the prior consent of the investors which are party in term sheet negotiations. When entrepreneurs breach these provisions, entrepreneurs can be liable for any expenses of the investors so far when negotiating the investment.

4.1.7.2 Confidentiality

It is in the interest of the entrepreneurs, the start-up and the investors that any information about the investment and the term sheet is confidential and shall not be discussed to any third parties.[161] Besides the investment terms, high-tech start-up have very sensitive information for exercising their business, this is why the investors also should need to sign a confidentiality agreement with the company.

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[159] The exclusivity clause can also be called 'no shop agreement'.

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

[161] The terms offered should not be disclosed to any third parties, because this information can be used by other investors to offer more improved terms to the entrepreneurs and steal the deal.

4.1.7.3 Conditions Precedent

The Conditions Precedent presents a road map to completion of the financing that is proposed by the term sheet.[162] It details the due diligence that must be completed once the term sheet has been agreed upon and highlights that a round of financing is not completed until the final purchase and sale agreement has been signed by the investors, any amendments are done to the articles of association and the money is in the bank.[163]

4.1.7.4 Closing Date, Legal Fees, Expiration and Governing Law

These last provisions are straight clear provisions regarding the closing date, the fees to professionals of the parties, the expiration date of the term sheet and the governing law that regulates the term sheet. The Closing date is the date on which the deal will be closed. This date has to be realistic, because often additional time is needed to draft the legal documents and with a time pressure a mistake is easily made.[164] Mostly, parties have to bear their *legal fees and expenses* with regard to the transaction themselves. The *Expiration date* is basically the date of which the offered term sheet expires. When the entrepreneurs do not sign the term sheet within a certain period of time, the offer expires. The *Governing Law* determines under which law the contract is governed. This can be the law of the entrepreneurs' jurisdiction, the companies' jurisdiction or investors' jurisdiction and is determined in the negotiations.

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

[163] A. Wilmerding, '*Term Sheets & Valuations – A Line by Line Look at the Intricacies of Venture Capital Term Sheets & Valuations'* (2003) p. 70-71

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

5. The Terms Sheets Compared & the Recent Developments of the Term Sheet

In the last chapter we have discussed the provisions that can occur in the term sheet. But as every investor and start-up is different, the provisions in the term sheet are different too. In this chapter we are going to discover what characteristics of investors are causing these differences in the term sheet. We will discuss the different type of investors and explain which provisions they typically use in their term sheet.

5.1 The Traditional Business Angel Term Sheet

The traditional business angels are filling the funding gap of time and capital.[165] In this first stage of start-ups, risk and uncertainty are the highest. This highly risk and uncertain investment would make one believe that compared to venture capital investments, the angel term sheet would be more comprehensive and contain more protection for investors.[166] But the opposite is true, traditional business angels use term sheets that have less protection compared to venture capital term sheets. Business angels can rely on their close relationship with entrepreneurs. They use term sheets that are not too comprehensive, costly and time consuming to design and negotiate. Often their term sheets exits only of a few pages and even sometimes they are using a so called 'one page term sheet' with provisions that are easier to digest for entrepreneurs and are based on alignment and fairness.

First, the amount traditional angels invest differ from that of angel groups and venture capitalists. Most amounts invested by traditional angels are between 50 000 and 2 million dollar.

Second, traditional angels most often invest in common shares instead in preferred shares.[167] Common shares create the best alignment governance and are the simplest to use for angels. But as discussed before, investing in preferred shares gives the investors a better opportunity to protect their investment. The decision whether to invest in preferred or common shares can be determined by the fact if an angel has faith in the board of directors of the start-up and the size of the investment.[168] When there is faith in the board of directors and faith in an exit, investing in common shares is not a big risk. When there is less faith in the board and an exit of the start-up, investing in preferred shares gives the investor protection and is therefore a better decision. Also when investing in larger amounts of capital, better protection is

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[165] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1417
[166] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1421
[167] A.Y. Wong, 'Angel Finance: The Other Venture Capital '(2002) p. 19. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941228 >
[168] Basil Peters, 'The evolution of the Term sheet part 1 a Seminar for Bellingham Angel Group' November 17 2009. *Exits.com* available at http://www.exits.com/blog/angel-term-sheet-evolution-part-1

recommended and therefore preferred shares are more often used in the bigger investments.

Third, traditional angels do not stage their investments. When traditional angels invest in a round and venture capital comes in at a later stage, research has shown that angel investors are unlikely to participate.[169] This finding confirms the fact that traditional angels are financing only to make sure the start-up is growing, so the venture capital can take over.[170]

Fourth, traditional angels mostly do not participate in the board of directors. Research shows that less than half of angels' investment involved obtaining a board seat in the start-up.[171] Although it is not common that traditional angels use board participation as a protection mechanism, board participation is a protection mechanism that is more common than other venture capital protection mechanisms such as stage financing.

Next to this, traditional angels often do not use special approval items for investors. This means the investors have less contractual influence in the decisions boards make.

Also, traditional angels use specific exit rights less frequently. Angels are unlikely to specify a method of liquidation at the time of the investment.[172] Also, not always a real redemption provision is provided in the term sheet, but a call-option for the entrepreneur is provided to redeem the angel's shares.[173]

The question arises why angels use these non-comprehensive term sheets when they are investing is these risky and uncertain start-ups? First, traditional angel investors know that they are the first to invest in the start-up but not the last. Angels bridge the gap between the friends and family investors and the venture capital investors. This means traditional angels know they will be followed by venture capitalists, and this is also where the angels make their money. When angels use complicated contracts, it becomes harder for venture capitalists to come in, because they first need to unwind the angel contracts which can be very costly.[174] Imagine angels have obtained control rights, board seats and liquidation preferences. Venture capitalists will never enter a start-up if they cannot obtain their usual control mechanisms, and when angels are in their way, they must share it with these angels. A comprehensive term sheet will push away any interested venture capital and therewith the success of an angel investment.

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[169] A.Y. Wong, 'Angel Finance: The Other Venture Capital' (2002) p. 4. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941228 >

[170] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1422

[171] A.Y. Wong, 'Angel Finance: The Other Venture Capital' (2002) p. 18. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=941228 >

[172] M. Van Osnabrugge & R. J. Robinson, '*Angel investing: Matching start-up funds with start-up companies- The guide for entrepreneurs, individual investors and venture capitalist*' (2000). p. 199

[173] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1424

[174] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1429

Second, the relation between the entrepreneurs and the angel provides informal substitutes for comprehensive protective provisions.[175] During the whole investment process the traditional angel is closely and actively involved with the development of the start-up. This is because traditional angels seem to invest geographically nearby so they can visit and monitor their investment. He is not only a mentor of the entrepreneur but also mostly an expert in the field in which the start-up is operating. Being a mentor creates a high knowledge of what goes on in the start-up and what must be done, and being an expert in the operating field of the start-up the angel can better estimate the start-up's changes, reducing the information asymmetries that arise in an investment round.[176] This relationship between entrepreneurs and the traditional angels makes it possible to rely on this relationship to monitor and screen their investment instead of using monitoring rights and control mechanisms which are used in comprehensive term sheet used by venture capitalists.

Third, the amount angels invest is relatively low and for a short period of time especially compared to venture capital investments. The costly contracting theory explains that when the costs of a comprehensive term sheet is not beneficial, it is better to use a more simplified contract.[177] This explains why it is not beneficial for traditional angels to use comprehensive contracts.

Finally, the risk involved with start-up investment done by traditional angels is to lose the money invested. But making return on investment is not the only goal traditional angels have when investing in start-up. Traditional angels are often former entrepreneurs themselves who had success in the past and now miss the excitement that developing a business gives. Angels want to give something back to the community, and share their knowledge and experience with new young entrepreneurs. The term sheets traditional angels use do not have comprehensive protection provision, just because securing the risks is not particularly necessary for them. The possibility to make the investment with personal funds is already a luxury, this on the contrary to venture capitalists that face downstream pressure to satisfy fund investors.[178] Because traditional angels have also non-financial goals when it comes to making investments, an incomprehensive term sheet is sufficient.

5.2 Angel Groups Term Sheet

Angel groups made angel investing more professional and therefore also their protection

[175] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1431
[176] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1433
[177] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1434
[178] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1438

methods for risk, information asymmetries and agency costs. A MIT's Entrepreneurship Center study shows that angel groups are moving towards a more venture capital like model when it comes to their investment contracts.[179] Angel groups cannot rely on the informal substitutes like traditional business angels do. Their more arms-length relationship with entrepreneurs, wide portfolio and higher amounts of investments makes them use more comprehensive contracts. Each angel group has evolved a fairly standard set of terms they apply when making an investment deal.

Because angel groups show more resembles with venture capital than traditional angels do, they also most often invest in preferred instead of common shares. As we have seen these shares gives the investor substantial powers compared to common shareholders.

When investing in preferred shares, dividend provisions and provisions on conversion will obviously be included in the term sheet. Also a liquidation preference, anti-dilution protection and a redemption provision are likely to be part of the angel group term sheet.

To protect their investment angel groups cannot rely on the relationship with entrepreneurs as traditional angels do. Instead of a close relationship angel groups use term sheet provisions to monitor their investment. They often elect a director of the board of directors and require information and registration rights from the start-up. When there are no board seats secured, board observation rights such as the right to attend and participate board meetings are included in the term sheet.[180] These provisions mitigate any agency costs and information asymmetries that arise from the investment. Also they obtain drag-along rights and right of first refusal in their term sheet, which gives angel group control over the potential sell of all the shares or right to buy other shares.

Angel groups can also decide whether or not they include employee matters in their term sheet. What they most likely will include when investing in preferred shares is the vesting of the common shares. Vesting creates a commitment to the start-up with the common shareholders and founders are the holders of common shares. This provision thus creates commitment by the founders to the start-up and therefore founders have a greater incentive to develop the start-up and maximize the value of the shares. Besides maximizing the value of the shares it also shows that the angel group is serious about the investment and is determined that they are here to stay, till all shares are vested.[181]

[179] MIT Entrepreneurship Center, Venture Support Systems Project: Angel Investors 28 (2000) & D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1446

[180] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1447

[181] Basil Peters, 'The evolution of the Term sheet part 1 a Seminar for Bellingham Angel Group' November 17 2009. *Exits.com* available at <http://www.exits.com/blog/angel-term-sheet-evolution-part-1>

The confidentiality and exclusivity provisions are basically always included in the term sheet. These provisions protect the term sheet of the angel group, it prohibits the entrepreneurs to disclose the details of the term sheet which can lead to a bidding war with other angel groups. The exclusivity provision prevents the entrepreneur to go shopping for other investors.

This overview confirms the statement that angel groups show better resemblance with a venture capital. Angel groups are tending to be viewed by venture capitalists as the equivalent of early-stage venture capital which allows them to contract accordingly to a venture capital.[182] Also angel groups have a more arms-length relationship with entrepreneurs and therefore have to rely on protective mechanisms in their term sheet to protect their investment. Next to this, when traditional angel motivation is to transfer their knowledge and experience the excitement that is accompanied by investing start-ups, angel groups motivation has a more collaboration factor between individual angels that are part of the angel group.[183]

5.3 Venture Capital Fund Term Sheet

The main goal of venture capital investments is to get a high return on investment within a certain period of time. Venture capitalists do not attach value to interaction with entrepreneurs and extension of their network which is one of the most important motivations of angels. When investing in high risk start-ups the principle-agent problem occurs, where the entrepreneur is the agent and the venture capital is the principle. The principle is required to take precautionary measures to ensure that the agent will be less inclined to act opportunistically.[184] Due to the risky investment and the high amount the venture capital invests, they deal with comprehensive term sheets to protect their investments which will be discussed below.

Venture capitalists invest in preferred shares which gives them extensive control rights. These control rights such as the right to veto changes in the certificate of incorporation, and the control in the board of the start-up gives the venture capitalists the possibility to control and monitor their investment.[185] Next to this, preferred shareholders cannot claim the right to fiduciary duties because this duty only relates to common shareholders. Therefore venture capital funds protect themselves with contract provisions. The powers that are accompanied with preferred shares are outlined in more detail in the term sheet.

[182] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1449
[183] D. M. Ibrahim, 'The (Not So) Puzzling Behavior of Angel Investors', *Vanderbilt Law Review* (2008), Vol. 61 p.1450
[184] J. A. McCahery & E. P. M. Vermeulen, 'Limited Partnership Reform in the United Kingdom: A competitive, Venture Capital Oriented Business Form, *Tilburg Law and Economics Center Discussion Paper,* No. 2004-024 p. 15. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=664166>
[185] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 104

One of the powers accompanied with preferred shares are liquidation preferences.[186] The liquidation preference can contain a multiple of the original purchase price which not only assures the venture capital to secure its investment, but also assures a return on its investment. Also the liquidation preference protects the venture capital from an entrepreneur who overvalued its start-up. But as the entrepreneur holds common shares, he will not receive anything when the value of the company turns out to be greater than any liquidation preferences given to the venture capital.[187]

Also the preferred shares will be automatically converted into common shares in case of an exit of the start-up due to the automatic conversion provision. And the conversion provision provides the preferred shareholder with the possibility to convert their shares into common shares at any time and generally to a one-to-one conversion ratio. This gives the venture capital the possibility to convert their preferred into common in the event of a liquidity that is likely to raise a higher return on investment than the multiple return on investment that derives from the liquidation preference provision.[188] Other provisions on the preferred shares that are in the venture capital term sheet are voting rights, anti-dilution protection, redemption and the setting of milestones.

Special attention is needed to the board of directors of the start-up when venture capitalists invest in preferred shares. This provision creates the possibility for venture capitalists to elect one or more members in the board of directors to represent the fund. Board representation is a way to acquire control over the start-up.[189] Board control gives the venture capital the power to manage the start-up and by this way can initiate fundamental transaction such as mergers, IPO's and liquidations.[190] Besides control, the venture capital has the

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[186]Fred Wilson, '*The Three Terms You Must Have in a Venture Capital Investment'* avc.com, apr 10 2009. Available at < http://www.avc.com/a_vc/2009/04/the-three-terms-you-must-have-in-a-venture-investmemt.html >
The liquidation preference is according to Fred Wilson on his blog one of three key provisions that venture capital funds must have in their terms of investment. He explains that the liquidation preference is basically a option to get your investment or negotiated ownership back, whichever is worth more.

[187] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 116

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

[189] Fred Wilson, '*The Three Terms You Must Have in a Venture Capital Investment'* avc.com, apr 10 2009. Available at <http://www.avc.com/a_vc/2009/04/the-three-terms-you-must-have-in-a-venture-investmemt.html>
The right to a board seat is according to Fred Wilson another key provisions that the terms of investment must have when venture capitalist invests. He explains that you cannot have real impact on an investment if you do not have one. It is the best way to make sure your investment is going well, and when it is not, the board seat gives you the right to have a say in what is needed to fix the investment.

[190] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 120

possibility to closely monitor the management and thereby their investment. Because parties have different goals, these agency costs are mitigated by the board representation of the preferred.[191]

Another way to protect the venture capital investment is the protective provision in which certain items first need to be approved by the preferred shareholders. Aligned with this provision is the board approval item provision. Whereas the venture capital has required board control, approving certain actions of the company mitigates agency costs and information asymmetries that can arise.

The venture capital will also provide the term sheet with an information rights provision which gives the venture capital access to financial statements and often even access to any document of the start-up. This provision is another way to monitor the investment and reduce information asymmetries. In the US venture capitalists also obtain registration rights in case of any initial public offering in the future. Also the venture capital will obtain for a right of first refusal and drag along right in the term sheet and just like the angel groups, the venture capital can include an employee matter section where they will vest the shares of the common shareholders to create an incentive to perform and commit to the start-up.

Finally, the term sheet will contain just like the traditional angel and angel group term sheet a confidentiality and exclusivity clause. This will make the term sheet confidential so they cannot be part of a bidding war with other venture capitalists and it prevents the entrepreneurs to shop for other venture capitalists when they are already in negotiations with one. In conclusion, the term sheet of the venture capital is a more comprehensive one than the traditional angel and angel group term sheet. This is because venture capitalists have to protect themselves and their investment from agency costs and information asymmetries that arise in these early-stage and high risk investments. Protection is established by using preferred shares and the associated. These provisions shape the model of venture capital financing as we know it today.

[191] J. M. Fried & M. Ganor, 'Agency Costs of Venture Capitalist in Startups', *New York University Law Review* (2006), Vol. 18, p. 120

5.4 Development of the Start-Up Financing World and the Consequences to the Term Sheet

The start-up financing world has changed since the financial crisis.[192] Before, the ideal scenario was the start-ups presenting their idea, angels or angel groups invests and along with them venture capital comes in, with the result of a successful IPO. But this model has changed due to the negative influence of the financial crisis, as we have seen in chapter 3.2 where the drop of successful initial public offerings is explained. For both the angel and venture capital industry things have changed, new investors such as incubators and accelerators are growing in numbers. The changes to the start-up financing world are explained in this paragraph and if these changes affect the term sheet of these investors.

5.4.1 Incubators and a New Generation of Accelerators

Start-up companies in their seed stage do not necessarily stand alone when they are looking for investors such as business angels and venture capital. Incubators and accelerators provide start-ups a guidance to the next stage of their business development and in the end hope to provide the start-up with investors. Incubators and accelerators are seed stage programs to develop a business idea in to a real business.

Incubators provide management and capital to the team of entrepreneurs to develop an idea that was established internally by the incubators.[193] The incubator takes part in the start-up by receiving equity in the company for his services. Accelerators are a more new type of model of start-up funding, they typically provide an intensive program to develop the business idea in return for equity of the company. The difference with incubators is that accelerators compress the timescale for start-ups by operating as a type of 'boot camp'.[194] Y-Combinator is a good example of this new model of start-up funding. Y-Combinator invests a small amount of capital in a large number of start-ups. They let the start-ups come to Silicon Valley for three months where they work with the entrepreneurs to get the company in the best possible shape. In the

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[192] J. Block & P. Sandner, '*What is the Effect of the Current Financial Crisis on Venture capital Financing? Empirical Evidence from US start-ups',* MPRA Paper No. 14 727 April 2009 and; J. M. Mendoza & E. P. M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p.2. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

[193] Christina DesMarais, 'Accelerator vs. Incubator: What is the Difference?*' Inc.com*. feb 7 2012 Available at <http://www.inc.com/christina-desmarais/difference-between-startup-accelerator-and-incubator.html>

[194] Martin Zwilling, 'Thoughts on Start-ups by Investors that Fund them & Entrepreneurs that Run them: Start-up accelerators are Entrepreneurs Boot Camps*' gust.com*, Oct 1 2012. Available at <https://gust.com/angel-investing/startup-blogs/2012/10/01/startup-accelerators-are-entrepreneur-boot-camps/>

end of the three months program they organize a meeting with investors where the entrepreneurs can pitch their idea in order to get investors interested.[195] Both accelerators and incubators are offering a platform to start-ups and investors to find each other.

Incubators and accelerators are investing in start-up companies themselves by requiring shares for the contributed capital to the start-up. This means they act as investors as well, and therefore use term sheets. The term sheets of incubators and accelerators have typically low pre-money valuations, this due the fact most start-ups are just ideas which are underdeveloped and therefore low in value. Also a low valuation helps investors to get a higher return on investment and the possibility for the next round of financing to be an up round increases.[196] The type of securities they invest in can differ; one is choosing for common shares and the other for preferred. Because incubators and accelerators have a close relationship with entrepreneurs, they do not need the protection provision that preferred shares offer and therefore common shares which dilute along with the founders will be the best option. Some incubators and accelerators decide for an option pool. Option pools, as explained before, are shares reserved for employees of the start-up, which motivates employees to do a better job because a good performing start-up has higher value shares which in its turn give higher returns to the employees in the event of any exit. Most important for start-ups is that term sheets of incubators or accelerators do not block future financing rounds. The ratio of incubators and accelerators is that they are guidance from only a business idea to a well-structured start-up, their main goal is to develop the start-up and make the business model a success in order to attract new investors. In my opinion this ratio has as a consequence that having a term sheet which blocks or troubles future rounds of financing is not a logical one.

5.4.2 Angel Investors Developments

Angel investments are now tending to be more successful when they invest alone instead of co-investing with venture capital.[197] When a venture capital co-invests, the chance to failure increases due to the higher risk venture capital funds take. Also the exits of lower valuated start-ups drops because venture capital funds will prevent exits and instead let the start-up mature. Venture capitalists prefer exits of higher valuated start-ups but this is when investments is

[195] <www.ycombinator.com>

[196] Ryan Roberts, ´How to Evaluate the Offer from a Start-up Incubator? Start-uplawyer.com feb 4 2011. Available at <http://startuplawyer.com/startup-issues/how-to-evaluate-an-offer-from-a-startup-incubator>

[197] When using the term angel investors in this paragraph we refer to traditional business angels and angel groups.

matured for a longer period. [198] And even when they have matured for a longer period, the returns are not as good to angel investors as they are for venture capital funds.[199] The venture capital cycle, is extended from a typical three to five years towards a five till eight or even 12 year cycle.[200] This means for angel investors, when a venture capital comes in, their investment is extended with these years and their risks increases substantially if they want to pursue a successful exit.[201] Without a venture capital to come in, angel investors can exit the investment between two to six years. The question arises if venture capital should come in when angels are investing as well? This depends on the situation and the type of the start-up which is explained in the table below (Figure 5).

	Angels Only	**VC Only**
Amount of capital required to prove the business model	Under $5-10 million	Over $ 5-10 million
Years before being able to exit	2 to 5 years	Over 10 to 12 years
Most likely value of the company at the time of the optimum exit	Under $50 million	Over $100 Million

Figure 5

Source: Basil Peters in Angel Investing in the 21st Century, Eearly Exits Workshop part 1, *presented at the Angel Capital Association National Summit, San Francisco May 5 2010*

Nowadays exits of start-ups are more often smaller acquisitions instead of big initial public offerings. Bigger companies are acquiring smaller start-ups with potential good ideas

[198] Robert Wiltbank, and Warren Boeker, 'Returns to Angel Investors in Groups' November 1, 2007 & Basil Peters in Angel Investing in the 21st Century, Eearly Exits Workshop part 1, *presented at the Angel Capital Association National Summit, San Francisco May 5 2010*

[199] Bill Payne, 'Follow-on Funding: A Dilemma for Angel Investors', Blog: 'Thoughts On Start-ups by Investors that Fund them & Entrepreneurs that run them'. *Gust.com* Jan 31 2012. Available at <https://gust.com/angel-investing/startup-blogs/2012/01/31/follow-on-funding-a-dilemma-for-angel-investors/>

In this article Payne explains that not only venture capital funding can lead to a lower return but also a follow-on funding round of the angels themselves seem to generate lower returns as when angels only invest in a single round.

[200] J.M. Mendoza & E. P. M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity' (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p. 10 figure 5. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

[201] Basil Peters in Angel Investing in the 21st Century, Eearly Exits Workshop part 1, *presented at the Angel Capital Association National Summit, San Francisco May 5 2010*

instead of developing on their own, and develop the idea to a full grown business.[202] This makes these companies sort of competitors for the venture capital market, as they acquirer start-ups to develop them under their wings. These early exits are often the strategy of the investors to exit their investment at a certain time and at a certain valuation. A successful exit starts with a good exit strategy and with the alignment of investors.[203] The alignment of investors can be a serious problem in the start-up but this is where the new emerging secondary market can play a crucial role. When investors are not aligned, shares can be offered on the secondary market in order to find investors who share the same exit strategy.

Now the question arises if these developments affect the term sheets of angels? As we explained before angels now tend to use preferred shares to mitigate risks like venture capitalists do. But angel investors want to establish term sheets that are reasonable for entrepreneur too and both take a share in upside rounds. This is why angels nowadays use preferred shares with terms that are less hard for entrepreneurs compared to the preferred terms used by venture capital.[204] Next to this, angels nowadays are better off without co-investing with venture capital, which means where in the past angels were willing to invest alongside and prepare the company for venture capital involved, angels now prefer to invest alone or with other angels and prevent venture capital to come in. Protective provisions can be adapted to make it harder for venture capitalists to become involved in the start-up because the consent of the preferred shareholders is needed when issuing new shares. Besides this, the development of the start-up financing world needs term sheet for angels to be one that creates a good governance and corporate structure which is based on alignment and fairness and last but not least to keep it simple.

5.4.3 Venture Capital Developments

The success of venture capital funds can be attributed to the traditionally IPO. But with the fallback of the number of successful IPO's, venture capital success dropped. The number of venture capital funds declined, leaving only the high quality funds active. Most venture capital funds nowadays prefer their start-ups to be acquired by other companies instead of going

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[202] Examples of acquisitions of start-ups (which have developed only several years) by bigger companies and for valuation estimated under $50million are Google buying Adscape and Blogger and Yahoo buying Flickr.

[203] Basil Peters in Angel Investing in the 21st Century, Eearly Exits Workshop part 2, *presented at the Angel Capital Association National Summit, San Francisco May 5 2010*

[204] Dan Rose in the Term Sheet Evolution part 2, *presented to the Bellingham Angel Group Education Breakfast, Exits.com* Nov 17 2009. Available at <http://www.exits.com/blog/angel-term-sheet-evolution-part-2> Here Dan Rose explains this kind of preferred shares as 'series a preferred light'.

public.[205] Also the life cycle and amounts of investments of venture capital firms is extending. Traditional venture capital funds are getting larger and larger and so is their minimum investments size, also they are moving to a later stage of the start-up lifecycle.[206] This means that the time between the incorporation of the start-up and the venture capital investment has increased as well.[207] Next to these changes, new generations of venture capital funds are developing such as micro-venture capital funds, pledge funds, fund of funds, joint venture funds and the corporate venture capital fund.[208] These new venture capital funds stick with more early stages investments and their fund managers are getting more actively involved.

The micro-venture capital fund (or also called super angel funds) is based on a partnership strategy between the fund managers and the investors. Micro-venture capital funds have both characteristics of angels and venture capitals. Thus the fund managers are often former entrepreneurs who cannot only manage the fund but also find winners and be a mentor to the start-up.[209] Another characteristic is that the fund managers also contribute a significant amount of capital to the fund.[210] This makes the fund managers more committed to the micro-venture capital fund.

Pledge funds (also known as synthetic funds, call funds or fundless funds) are, just like micro-venture funds, a combination of venture capital funds and angel investors. The fund is managed by experienced venture capitalists or business angels, but the investor has the

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[205] J.M. Mendoza & E.PM. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity' (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p.2. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 > 'Venture capitalist prefer trade sales for regulatory reasons, they offer immediate liquidity without onerous lock up periods, costly disclosure requirements and obligations for venture capitalist to maintain board seats.'

[206] J.A. McCahery, and E.P.M. Vermeulen, 'Conservatism and Innovation in Venture Capital Contracting' (February 12, 2013). Lex Research Topics in Corporate Law & Economics Working Paper No. 2013-2 p. 8. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215896 >

[207] J.M. Mendoza & E.PM. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p.2. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

[208] E.P.M. Vermeulen & D. Pereira Dias Nunes, 'The Evolution and Regulation of Venture Capital Funds' (October 17, 2012). *Lex Research Topics in Corporate Law & Economics* No. 2012-1 p. 46. Here is explained that the financial crisis has lead to a new venture capital cycle with new types of investors and new opportunities. This has also consequences for the limited partnership agreement and thus the corporate structure of the venture capital fund. & J.A. McCahery & E.P.M. Vermeulen, 'Venture Capital Beyond the Financial Crisis: How Corporate Venturing Boosts New Entrepreneurial Clusters (and Assists Governments in Their Innovation Efforts)' (May 29, 2010). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2010; Tilburg Law School Research Paper No. 011/2010 p. 23-27. Available at< http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1617585 >

[209] J.A. McCahery, and E.P.M. Vermeulen, 'Conservatism and Innovation in Venture Capital Contracting' (February 12, 2013). Lex Research Topics in Corporate Law & Economics Working Paper No. 2013-2 p. 18. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215896 >

[210] E.P.M. Vermeulen & D. Pereira Dias Nunes, 'The Evolution and Regulation of Venture Capital Funds' (October 17, 2012). *Lex Research Topics in Corporate Law & Economics* No. 2012-1 p.36

possibility to decide to invest in a start-up on a deal-by-deal basis. This means managers have to ask for consent to the institutional investors before deciding to invest in a start-up. Institutional investors pay an annual fee in order to make this deal-by-deal decision. By this way, high management fees and carried interest are avoided and institutional investors have more control over their investments, but on a downside transactions are more time-consuming and expensive.[211]

A fund of funds is an investment vehicle that mainly invests in other funds to maintain a higher degree of control and transparency over the fund's portfolio companies and investment decisions.[212] The downside of a fund of funds is the payment both funds' management fees. Fund of funds offer diversification and help to reduce risk but provide similar returns. The primary point of fund of funds is not whether they outperform other indices or markets, but whether they provide a similar return for much less risk.[213]

Joint ventures funds are collaborations between different venture capital funds or other investors. They profit from each other's expertise, reputation and experience to improve their portfolio investments. Also, the involvement of a joint venture funds in a start-up attracts the interest of other investors. When other investors notice that a high-profile joint venture capital is involved, the start-up has a greater opportunity to become a success and therewith a successful exit for their investment.

Special attention must be given to corporate venture capital funds. As we have seen in the previous paragraph, major companies prefer acquiring certain start-ups instead of investing in research and development themselves. Not only can these companies' acquirer start-ups, they can also create their own venture capital fund to search for start-ups. This by not only searching for an investment, but also by creating the possibility to be part of the development of an innovative idea, which, in turn, could spur the innovation of the company.[214] The corporate venture capital can also provide the start-up access to industry experts, alumni network, technology facilities and more in order to stimulate the development of the start-up.[215] The involvement of a corporate venture capital fund increases knowledge, investments opportunities,

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[211]E .P.M. Vermeulen & D. Pereira Dias Nunes, 'The Evolution and Regulation of Venture Capital Funds' (October 17, 2012). *Lex Research Topics in Corporate Law & Economics* No. 2012-1 p. 32

[212] E.P.M. Vermeulen & D. Pereira Dias Nunes, 'The Evolution and Regulation of Venture Capital Funds' (October 17, 2012). *Lex Research Topics in Corporate Law & Economics* No. 2012-1 p.32

[213] A.Lowcock in *'£1.1 bn investment surge in fund of funds'* by Tanya Powly. Available at <http://www.ft.com/cms/s/0/62396f74-e139-11e1-9c72-00144feab49a.html#axzz2OHK5NRO4>

[214] E.P.M. Vermeulen & D. Pereira Dias Nunes, 'The Evolution and Regulation of Venture Capital Funds' (October 17, 2012). *Lex Research Topics in Corporate Law & Economics* No. 2012-1 p.39

[215] Google ventures provide start-ups in which they invest with industry experts, alumni network, technology facilities etc.

deal flow and exit opportunities of a start-up.[216] When the company is involved in the development of the start-up, they will also be having more interest in acquiring the start-up in order to become part of the company.

The discussed new generations of venture capital funds are a reaction to the financial crisis. Investors are getting more risk-averse and conservative and by these new generations of funds, investors have a better monitoring position and control over their investment.[217] This means the high-risk venture capital investments are becoming less risky.

Also, incubators, accelerators, angels, angel groups and the new generations of venture capital funds have filled the gap before traditional venture capital funds will be involved. The involvement of these other investors makes it harder to find a good exit strategy due to different interest in exits and less alignment. As I will explain in the next paragraph, the secondary market plays an important tool in these new trends.

The term sheet of venture capital funds are not particularly changing to these conditions, although changes in venture capital structure will cause changes to the limited partnership agreement. The entrepreneur and venture capital relationship does not differ from the relation between the original venture capital and the entrepreneur in better financial times. Although in some of the new generation of venture capital funds, angels are involved but this does not mean that they use traditional business angel terms. The investments are structured via venture capital funds which have wide portfolios and therefore are best managed by contractual provisions of a preferred term sheet, just like traditional venture capital funds and angel groups. The National Venture Capital Association created a term sheet that contains the so called 'heavy preferred shares' which is often used by original structured venture capital funds.[218] The newer generations of funds are trying to be more aligned with entrepreneurs and act more entrepreneur friendly compared to the original venture capital funds.[219] For example, the micro-venture fund 'Founders Funds' created a more transparent term sheet by offering a tool on their website which calculates how option pools, dilution and liquidation preferences impact returns

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[216] J.A. McCahery, and E.P.M. Vermeulen, 'Conservatism and Innovation in Venture Capital Contracting' (February 12, 2013). Lex Research Topics in Corporate Law & Economics Working Paper No. 2013-2 p. 21. Available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2215896 >

[217] E.P.M. Vermeulen & D. Pereira Dias Nunes, 'The Evolution and Regulation of Venture Capital Funds' (October 17, 2012). *Lex Research Topics in Corporate Law & Economics* No. 2012-1 p.33

[218] Available at <http://www.nvca.org/index.php?option=com_content&view=article&id=108:model-legal-documents&catid=43:resources&Itemid=136>

[219] See for example Founders Fund, who is offering value added services like recruiting general partners that have significant operating experience. From & K.M. Cutler, 'Founders Fund Launches A More Transparent Term Sheet' *Blog TechCrunch.com*. Available at <http://techcrunch.com/2012/08/20/founders-fund/>

for founders in different exit scenarios. [220] Being more entrepreneur-friendly does not clearly appear from the term sheet but new venture capital funds offer more alignment and value added services.[221] What is actually changed, are the valuations of the start-ups they invest in. Due to the fact traditional venture funds moved to a later stage investment, start-ups are more developed and therefore of a higher value. Also the amount of investment has changed this because of the fact that venture capital funds have increased the size of investments. On the contrary the venture funds who are investing in early stage investments will have lower valuations. The secondary market can have influence on the venture capital term sheet but this will also be discussed in the next paragraph.

5.4.4 The Secondary Market and its Consequences to the Term Sheet

The introduction of the secondary market is a result of the development of the start-up financing industry. In the venture capital cycle the time between incorporation and venture capital involvement in start-ups has increased, this has the effect that additional capital is needed to develop the company and eventually to a successful exit.[222] Traditional venture capital funds are making less risky capital intensive investments which in practice means they are investing at a later stage of the start-up development. Venture capital stepping into the start-up project at a later stage means that other investors have to fill the liquidity gap, as we have seen this is where angels and angel groups, micro-venture capital and other new variations of venture capital funds come in. But all these different investors in the start-up create the difficulty to align the interest of the investors, who often pursue different exit strategies.[223] As discussed above, alignment on exit strategies is a problem that occurs with angels investments as well. Investors stuck with a longer time period before an exit which creates liquidity, are in need of liquidity during this period as well. The secondary market supplies the necessary liquidity needed, by

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[220] See <http://www.foundersfund.com/termsheet/> & K.M. Cutler, 'Founders Fund Launches A More Transparent Term Sheet' *Blog TechCrunch.com*. Available at <http://techcrunch.com/2012/08/20/founders-fund/>

[221] Micro-fund Founders Fund offer value added services to portfolios companies (http://techcrunch.com/2012/08/20/founders-fund/). Softtech VC spends time with their portfolio companies to make sure they have ' compatible personalities' and they offer a clean and simple term sheet (http://softtechvc.com/strategy/investment-process/). Felicis Ventures do not make investment decisions solely on based on potential exits size (http://www.felicis.com/about/). The joint venture capital fund Redpointe.ventures which specialized investments in Brazil use Silicon Valley terms and incentives favoring the entrepreneurs (http://rpev.com.br/approach/).

[222] J.M. Mendoza & E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity' (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p. 3. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

[223] J.M. Mendoza & E.P.M. Vermeulen, 'The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity' (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p. 3. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

offering shareholders a platform where they can sell their shares and gain the liquidity it needs and also find investors to align their exit strategies.

The secondary market for private shares has no transparency compared to the public market, where in the United States the SEC mandates an enormous amount of transparency including quarterly financial statements and complete publication of the company's cap table including all significant shareholders.[224] The emerging secondary markets lacks this transparency and therefore it is hard for outsiders to know the insides of a start-up and maybe most important; if the valuation is right. Some significant changes are needed to the practical, legal and economic sides of the start-up financing industry in order to make the secondary market work. Mendoza and Vermeulen suggest that governments, securities regulators and stock exchanges should work together with the venture capital industry to develop a marketplace in which the various players in the venture capital cycle can get more connected and engaged.[225]

The secondary market may fulfill the need for liquidity for investors, but for start-ups as an entity it can cause several problems. As mentioned above, different investors are hard to align when they pursue different exit strategies. Also when founders and key employees sell their shares on the secondary market, it takes away their incentive to perform. Start-ups can protect themselves against these problems by contractual restrictions on the transfer of shares in the term sheet. As explained in chapter four, the right of first refusal gives investors the right to acquire the shares offered by another shareholder before a third party can buy them. This means that other shareholders can keep the shares 'inside' the start-up instead of selling it on the secondary market.[226] Another contractual restriction in the term sheet to prevent selling on the secondary market is the co-sale agreement, which gives the shareholders the right to sell

[224] David Rose , 'What are the Regulatory Barriers Preventing The Emergence of a Liquid market For Equity in Seed Stage?' *Blog Gust.com* .Available at <http://gust.com/angel-investing/startup-blogs/2012/11/15/what-are-the-regulatory-barriers-preventing-the-emergence-of-a-liquid-market-for-equity-in-seed-stage-startups/>
Rose explains that the emerging secondary market lacks regulation compared to the public market. This has influence on the information for everybody outside the company and on the valuation of the start-up. Rose statest hat the emerging secondary market needs firstly some significant changes to the practical, legal and economic sides of seed investing.

[225] J.M. Mendoza & E.P.M. Vermeulen, The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p. 4. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 > Referring to the 'new' venture capital cycle as the extended time horizon for investors of start-ups before exits.

[226] J.M. Mendoza & E.P.M. Vermeulen, The 'New' Venture Capital Cycle (Part I): The Importance of Private Secondary Market Liquidity (May 3, 2011). Lex Research Topics in Corporate Law & Economics Working Paper No. 1/2011 p. 19. Available at < http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1829835 >

their shares with the founder or key employee who is its shares.[227] By this way, the other shareholders who are also in need of liquidity do not have to enter the secondary market individually which in its turn creates a more differentiation of investors, thus a more difficult alignment.

The secondary market changes the characteristics of the start-up financing industry. It offers liquidity, improves start-up governance and mitigates agency costs. On the downside, the secondary market can take away the incentive to perform. This all can affect the term sheet that investors and entrepreneurs agree upon. When agreeing on a term sheet investors and entrepreneurs can take into account the secondary market and its possibilities. The board approval clause can become an important tool in this case. This section can be changed in order for anyone, when there is the intention to sell shares on the secondary market, to consent the board of directors and need board approval. This means entrepreneurs, angels, venture capitalists or any other investor who is planning to enter the secondary market, the board of directors of the start-up has to give approval. It would not be efficient to require approval for every sale of shares on the secondary market, therefore a threshold can be obtained.[228] This protects the start-up against the selling of investors which can create different opinions in exit strategies and protects against entrepreneurs who are selling and as a consequence take away the incentive to perform.

Another way to prevent entrepreneurs to sell their shares to the secondary market and thereby lose the incentive to perform is by setting milestones and staging the investment. Milestones create incentives to perform because when they have not met the milestone, a new stage of financing can be restrained until the entrepreneurs have preformed. In addition to this, investors can only allow entrepreneurs to sell their shares after a milestone is met. At last, the board of directors can prohibit that entrepreneurs sell all their shares, but instead allow only partial sale of their shares.

With the introduction of the secondary market, the term sheet can play a role in controlling parties to enter into the secondary market and protect other parties in the start-up. But the most beneficial of the secondary market is that parties can exit the investment or start-up whenever they want. The secondary market mitigates agency costs, improves start-up governance and improves liquidity. When the term sheet makes it harder to profit from these advantages, the problems the secondary market resolved may strike again. This is why start-

[227] The Co-sale agreement often comes in when a change of control happens. Here it is suggested that it acts like a tag-along with the selling of the partial shares of a founder or key employee.
[228] A threshold can be around 10% of the company's shares

ups and investors have to decide for themselves if they want to contractually constraint the possibility to enter the secondary market, because this does not always have to be a good thing.

6. Conclusion

Technological start-ups play an important role in our economy nowadays. These start-ups have a business idea which at that time is worthless and only has potential to become a success if it has the possibility to mature. Development is made possible with the existing business angel and venture capital model. Where angels and venture capital work together and follow each other in investments to make start-ups a success. Business angels fill the funding gap that arises between the friends and family money and the venture capital investment which funds the start-up at a later stage. Next to this we found that a secondary funding gap occurs in high-tech start-up financing. This gap occurs when traditional business angels' investment is no longer sufficient because the amount exceeds their feasibility and it is too early for venture capital funds to come in. The secondary funding gap is solved with the introduction of the angel groups, where business angels pool their investments to create a larger amount for the financing of start-ups.

But start-ups do not only need the capital to develop their idea, they also need advice and guidance to make the start-up successful. This is why business angels play a critical role in the development of a start-up. We have seen that business angels do not only provide capital but also give crucial advice, guidance and a network in this crucial stage of the start-up. This role creates a particular close relationship between the angel and the entrepreneurs. Business angels rely on informal substitutes instead of creating comprehensive term sheets with protection provisions to protect the angels from agency costs and information asymmetries. Also the costly contracting theory explains that it is not beneficial for traditional business angels to create comprehensive contracts. Next to this, business angels attract venture capital funds to start-ups so they play a navigating role for venture capital funds.

Whereas business angels rely on informal substitutes, venture capitalists do not have a close relationship with the start-up. Besides this, their investments can be way higher than traditional angel's investments, which make it beneficial for them to create a comprehensive term sheet. These term sheet contains different provisions to protect the venture capital from information asymmetries and agency costs during the investment period. The main goal for venture capital funds is to make money and they do so by aiming primarily for an initial public offering and secondary an acquisition. With the introduction of the secondary market there is a new possibility for the venture capital to exit the investment. This possibility is mitigating the agency costs and benefits the governance of venture backed start-ups.

Between traditional angels and venture capitalists are angel groups, who show resemblance with both. They are traditional angels who pooled their investment and also

support the start-up with crucial advice and guidance but their term sheet is a venture capital like contract. They have a more arms-length relationship with entrepreneurs and they invest in higher amounts, which make it crucial to use a venture capital like term sheet.

The development of angel groups is only one of many developments of start-up financing. As venture capital funds are investing at a later stage and extending their investments time frames, start-ups and their early investors tend to decide for the early exit in the form of an acquisition by bigger companies. These companies have become competitors of venture capital funds when it comes to developing promising start-ups. Also the term sheet can be influenced by the recent developments of the start-up financing world, especially when it comes to controlling the possibility to enter the secondary market. Term sheets can contain special board approval terms or set milestones and provide the start-up with staged financing in order to control the entry of the secondary market. There is also the possibility to contractual allow the selling of only partial ownership on the secondary market instead of their full ownership. This means accessibility of the secondary market can be controlled by contractual provisions.

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