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CATALYZE

Resource
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This article is Part 2 of 7 in Venture Financing Process. Already up-to-speed on this topic? Skip to Part 3. Due Diligence or check out the full New GC & In-House Counsel Resources collection.

Proposing an Investment

If a VC firm finds a company's pitch attractive, it will typically commence some business due diligence in preparation for making an offer for investment. This might cover, among any number of other things, assessing the company's team, doing research on the company's market to pressure test metrics and assessing product-market fit. If the business due diligence goes well, the VC firm will move toward a huge milestone for the company: proposing an investment.

The Term Sheet

The initial proposal for the investment will be captured in a "term sheet" that covers the proposed investment amount, the value of the company, and a host of other high level terms and conditions. It's most often the case in a VC financing that the VC firm will create and offer the term sheet to a company, rather than the other way around (however, this is certainly not the case 100% of the time, though it's close).

While the term sheet will cover an array of various deal points, keep in mind that it is a non-binding document and will likely include explicit caveats and requirements before an investment can be finalized, like completing the remaining due diligence on the company and executing final investment documents.

Of the various deal points that can be covered in a term sheet, it will almost certainly include both a specified amount of the proposed investment (the “check size”) and a valuation of the target company—the two numbers that determine the percentage of the company that the investors would own upon completion of the proposed transaction. The valuation, along with the company’s capitalization numbers, will be used to determine the price of the shares to be issued in the financing.

Other items that might be covered in the term sheet include the rights and preferences of the preferred stock, if the investors will have specific voting rights and the composition of the board of directors (including if the VC Firm will require a board seat). In general, a proposed term sheet is subject to, and it’s likely expected that there will be, at least some level of negotiation between the company and the investor, and the company may choose to push on certain terms based on how it perceives its relative leverage. If there’s an appetite to negotiate, the term sheet may go a few rounds before being accepted by both sides. This period collectively makes up the term sheet stage, with the acceptance and execution of the term sheet then kicking off the legal due diligence and the document drafting stages.

Next Steps

If you receive a term sheet and you haven’t yet reached out to your Gunderson team regarding your financing, this is the perfect time. Your Gunderson team will be able to review the proposed terms with you and help you negotiate any key terms or catch any red flags. We can step in to take over the negotiation or remain in the background, but we always suggest getting us involved to help get the best outcome possible in this stage.

A note on operational matters for your company when you receive a term sheet

Be aware that when you receive a term sheet, you should check in with your Gunderson team regarding your equity compensation practices. It’s likely the case that your company should stop issuing any equity to employees or service providers, including under a stock option plan.

This is due to the fact that most startups rely on an independent valuation report, known as a 409A Valuation, in order to price their common stock in connection with issuing stock options. This independent valuation provides an avenue for startups to issue their options in compliance with IRS rules, specially Section 409A of the IRS code for which the valuation is named. The IRS requires that shares not be issued below their “fair market value,” else the delta between the issue price and the fair market value of the shares be subject to taxes and penalties to both the employee and employer (a closer look at these issues can be found elsewhere in these resources). Using an outside, independent firm that can perform a valuation pursuant to the IRS’s stated methodologies provides the company with a “safe harbor” pursuant to which the company can rely on the valuation report to apply a price to its shares of stock and know that such pricing will be valid in the eyes of the IRS. The report is generally good for the company to rely on for a twelve-month period, unless some material event occurs that causes the report to become ineffectual sooner.

Next section: Part 3. Due Diligence

Venture Financing Process

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