Term Sheets and Legal Documentation (Venture Capital)

Interview preparation summary · VC track

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INT.VL.1.a · The term sheet

Explain how seniority, accruing dividends, redemption rights and deemed-liquidation clauses shape what a preferred investor actually receives, and say what is market and what is aggressive.

A liquidation preference is only as valuable as its ranking, its add-ons and the events that trigger it. Seniority decides who is paid first: a senior class takes its preference in full before a junior class receives anything, whereas pari passu classes share a shortfall in proportion to their entitlements. Ranking matters only when proceeds fall below the combined preferences. A cumulative dividend accrues whether or not it is declared and is usually added to the preference on a sale, liquidation or redemption, and is often forfeited on conversion; a non-cumulative dividend is paid only if declared. A deemed-liquidation clause treats a merger or sale of substantially all assets as a liquidation, so the waterfall applies without a winding up. Redemption rights let holders demand repayment after a set date, but are limited by lawfully available funds and work mostly as leverage. Market practice varies, but a simple 1x non-participating preference without a dividend is commonly seen in competitive early rounds, while accruing dividends and senior stacking tend to appear where investors have more leverage. The usual mistake is to forget that accrued dividends raise the conversion break-even.

WORKED EXAMPLE: WHAT AN ACCRUING DIVIDEND DOES TO A SERIES A AT HARROWGATE LABS

Harrowgate Labs is an invented company. A Series A investor put in 6m for 25% of the company on a 1x non-participating preference with an 8% a year cumulative dividend. The dividend is simple, is paid only on a sale or liquidation and is forfeited if the investor converts. The Series A is the only preferred class and the company is sold at the end of year four. Compare the investor's proceeds with and without the dividend at exit values of 20m, 28m and 40m, and find the exit value at which the investor converts. Ignore tax and fees.

Answer: With the dividend the preference is 7.92m and the investor converts only above 31.68m, against 24.0m without it. The other holders pay 1.92m at 20m, 0.92m at 28m and nothing at 40m.

> **Interview tip:** State the conventions first (simple, forfeited on conversion, year-four sale). Then say that the dividend matters in the middle range of outcomes, not in a big win, which is why founders push to remove it and investors often accept a smaller version.

INT.VL.1.b · The term sheet

Explain the legal mechanics around anti-dilution (carve-outs and waivers), pay-to-play, pro rata and information rights, and say what is market and what is a red flag.

The anti-dilution formula is only part of the clause; lawyers also argue over what counts as a trigger. Excluded issuances, often called carve-outs, usually cover shares issued under an approved option plan, on conversion of preferred stock, in board-approved acquisitions or lender financings, and on stock splits, so that routine business does not move the conversion price. A waiver is commonly given by a specified majority of the affected preferred class and then binds the whole class, which is why a new lead in a down round asks for it. Pay-to-play requires an investor to take up its pro rata share of a later round or lose rights, usually by converting some or all of its preferred into common at 1:1, which removes its preference and anti-dilution protection. Pro rata and information rights are frequently limited to major investors above a minimum holding, so a holding that dilutes below the threshold can lose them. Investors want monthly numbers and prompt bad news; founders want confidentiality limits. A common mistake is treating pro rata as a duty rather than a right.

WORKED EXAMPLE: A PAY-TO-PLAY AT BRINDLE BIO

Brindle Bio is an invented company. A Series A investor holds 3.0m preferred shares, bought for 6m, which is 20% of the company. The company raises 10m at a 40m pre-money valuation. The new term sheet has a pay-to-play: an investor that does not take its pro rata share has its preferred converted to common at 1:1 in proportion to the shortfall. Work out the investor's pro rata amount, its ownership if it invests 0, 1.0m and the full amount, and what it keeps as preferred if it invests 1.0m. Ignore any option pool.

Answer: Its pro rata is 2.0m. Investing 0, 1.0m or 2.0m gives 16.0%, 18.0% or 20.0%. With a 1.0m cheque, 1.5m shares remain preferred with a 3.0m preference and 1.5m become common.

> **Interview tip:** Keep pro rata (a right) separate from pay-to-play (a penalty for not using it). Mention that the new lead usually asks for pay-to-play because it wants existing investors to share the risk of a hard round.

INT.VL.1.c · The term sheet

Compare post-money SAFEs, pre-money SAFEs and convertible notes on cap, discount, MFN, maturity and interest, including what happens in a sale or at maturity before a priced round.

A SAFE is a contract to receive shares at a later priced round or sale; it is not debt, so it has no interest and no maturity date. A convertible note is a loan that accrues interest and falls due at maturity, often 12 to 24 months out, which gives the holder leverage if no round happens. Both usually carry a valuation cap, a discount or both, and often an MFN clause that lets an early holder adopt better terms given to later holders. A post-money SAFE fixes each holder's percentage of the company capitalisation just before the priced round at the amount divided by the cap, so extra SAFEs dilute the founders and not other SAFE holders; a pre-money SAFE shares that dilution. If the company is sold before conversion, many forms pay the greater of the amount paid in and the as-converted value, while notes often add interest or a multiple. Note holders can in principle demand repayment at maturity, but usually agree an extension or conversion. The usual mistake is to treat a SAFE as free money that costs the founders nothing in ownership.

WORKED EXAMPLE: A SALE BEFORE CONVERSION AT KESTREL TIDE SOFTWARE

Kestrel Tide Software is an invented company with no priced round yet. It has one post-money SAFE for 1.0m with a cap of 10m, under a form that pays the greater of the purchase amount and the as-converted value on a sale, and one convertible note for 0.6m with 8% simple interest that is 14 months old. Assume the note is repaid in cash with its interest on a sale and does not convert. Work out what each instrument receives and what is left for the other holders if the company is sold for an equity value of 9m, and then of 14m. Assume the sale proceeds cover all claims and ignore fees.

Answer: At 9m the SAFE takes 1.0m, the note takes 0.656m and 7.344m is left. At 14m the SAFE takes 1.4m, the note 0.656m and 11.944m is left.

> **Interview tip:** Say that the exact payout depends on the form. Many SAFE forms give the greater of money back and the as-converted amount, and notes may add interest or a multiple, so read the sale clause before you quote a number.

INT.VL.2.a · Control and the long form

Explain board composition, protective provisions and voting thresholds, and judge which investor controls are market, which are aggressive, and who really holds a veto.

Control in a venture round sits in three places: the board, the protective provisions and the voting thresholds that decide who can block. Seed boards are often two or three people; at Series A a five-person board with two founders, one lead investor and one or two others is often seen, and how the independent director is appointed decides whether the independent is truly neutral. Protective provisions list actions that need preferred consent whatever the board decides: new senior or equal shares, a sale, charter changes that hurt the preferred, dividends, large debt, changing the board size. Market practice varies, but a veto over the annual budget or routine hiring is generally regarded as operational and aggressive. The threshold matters as much as the list: with several series, a majority-of-preferred vote can be controlled by one large holder, while a higher threshold or a series vote hands vetoes to smaller classes. Observer seats, often granted by side letter, carry no vote. Candidates often count seats and forget the vetoes.

WORKED EXAMPLE: WHO CAN BLOCK AT ALDER WHARF LOGISTICS

Alder Wharf Logistics is an invented company with three classes of preferred: Seed 1.5m shares, Series A 5.0m and Series B 3.5m, which is 10.0m in all. The charter requires the consent of the holders of a stated percentage of the preferred, voting together, for a sale of the company. Find which classes can block a sale on their own if the threshold is a majority (more than 50%), two thirds (66.7%) and 90%. Common shares are not counted.

Answer: At a majority only the Series A can block. At two thirds the Series A and Series B can. At 90% the Seed can block as well. The founders hold no vote in these thresholds.

> **Interview tip:** Test each holder by removing it and seeing whether the others still reach the threshold. It is a quick method an interviewer will respect, and it shows you think about vetoes rather than headcount on the board.

INT.VL.2.b · Control and the long form

Explain founder vesting, leaver provisions, acceleration, option pool terms and key-person clauses, work out what a leaver keeps, and describe how founder warranties and conditions protect the investor.

Investors back people, so the documents tie the founders' stake to staying. Founder vesting typically runs three to four years, often with a one-year cliff and sometimes credit for time already served; unvested shares are repurchased, usually at the lower of cost and fair value. Leaver provisions label the departure: a good leaver (for example death, ill health or dismissal without cause) usually keeps vested value, while a bad leaver (for example early resignation or misconduct) may lose unvested shares and, under some English-law style documents, may have even vested shares bought back at cost or at a discount. Acceleration is single trigger (vesting on a sale) or double trigger (a sale plus dismissal without cause); acquirers prefer double. Employee options often vest over four years with a cliff and a post-termination exercise window of around 90 days. Key-person clauses can restrict a founder's outside activity or give the investor rights if the person leaves. Founder warranties, usually capped and tested against a disclosure letter, back the facts the investor relied on, and conditions precedent list what must be true before money moves.

WORKED EXAMPLE: WHAT A DEPARTING FOUNDER KEEPS AT TAMSIN ROW GAMES

Tamsin Row Games is an invented company. A founder holds 3.0m shares bought at 0.01 each. On the Series A closing 25% of the shares are treated as vested for past service and the other 75% vest monthly over 36 months. The founder leaves at month 30. The current share price is 4.00. Work out how many shares have vested and the value of the founder's position if she is treated (a) under a US-style repurchase of unvested shares at the lower of cost and fair value, (b) as a good leaver whose vested shares are bought at fair value, and (c) as a bad leaver whose vested shares are bought at the lower of cost and fair value under an English-law style clause.

Answer: 87.5% has vested, which is 2.625m shares. Unvested shares are repurchased for 3,750. The founder keeps 10.5m as a good leaver and receives 26,250 as a bad leaver under the harsh clause.

> **Interview tip:** Say the treatment depends on jurisdiction and drafting: US practice usually repurchases only unvested shares, while some English-law documents reach vested shares for a bad leaver. Then focus on the definition of bad leaver.

INT.VL.2.c · Control and the long form

Explain right of first refusal, co-sale, drag-along and how escrows, earn-outs and carve-outs flow through the waterfall in a sale, and decide what to trade in a term sheet negotiation.

Transfer and exit terms decide who can sell, when and on what terms. A right of first refusal lets the company or investors buy shares a founder wants to sell before an outsider can; co-sale, or tag-along, lets investors sell alongside, usually pro rata to their holdings. Drag-along lets a specified majority force others to sell to a buyer on the same terms, which buyers want because they need all the shares; minority protections include a minimum price or return floor, equal treatment, several rather than joint liability and caps on indemnity exposure. In a sale, price is rarely all cash at closing: escrows or holdbacks cover warranty claims, earn-outs depend on later performance, and management carve-outs share part of proceeds with employees. All of these flow through the waterfall, so the documents must say who bears them. In a negotiation, ask what each side values: founders often care about control, vesting and headline price, investors about downside protection and ownership. A strong candidate trades terms with a reason rather than simply conceding.

WORKED EXAMPLE: ESCROW, EARN-OUT AND CARVE-OUT IN A SALE OF QUILLON SYSTEMS

Quillon Systems is an invented company. A Series A investor holds 20% as converted and a 1x non-participating preference of 8m. The company is sold for a headline price of 60m: 45m cash at closing, 6m in an escrow for 18 months and 9m of earn-out. A management carve-out of 5% of the closing cash is paid first. Assume the carve-out is taken only from closing cash, the escrow is released in full, the earn-out is 50% likely to be earned, and the investor converts. What does the investor receive at closing, later, and in expectation, compared with its headline share?

Answer: The investor converts. It receives 8.55m at closing, 1.2m from the escrow if released and 1.8m from the earn-out if fully earned. The expected total is 10.65m, which is 88.75% of its 12.0m headline share.

> **Interview tip:** Always separate headline, closing cash and contingent amounts. Then ask who funds the carve-out and who bears escrow claims, because the drafting can move value between classes.

Summary of the Charta interview-preparation topic. Companies and figures in the examples are invented. Draft content, not yet expert reviewed.