INVESTOR-FRIENDLY BEST PRACTICES FOR TERM SHEETS IN EAST AFRICA

ANDE LEGAL WORKING GROUP EAST AFRICA TOOLKIT

OPEN CAPITAL ADVISORS

This guide is intended for entrepreneurs and investors new to the process of negotiating term sheets, one of the first steps to close successful transactions. It is not intended to provide legal advice; instead it is meant to show examples of some common provisions that are not always easy to understand.

The examples below have been used effectively in transactions in East Africa, and many have been provided by organizations with significant experience in the region. It should be noted, however, that those who are experienced in investment transactions may have developed their own model term language that they prefer to use. Readers should understand the approaches and interests of the parties with whom they are negotiating as early as possible in their work together.

To supplement this guide, the ANDE Legal Working Group has produced a glossary of terms common to an impact investment transaction and plans to produce annotated term sheets for equity and debt transactions to be released in spring 2014 in conjunction with the International Transactions Clinic at the University of Michigan Law School.

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INVESTOR-FRIENDLY BEST PRACTICES LANGUAGE FOR TERM SHEETS IN EAST AFRICA

GENERAL CONSIDERATIONS

A term sheet is an agreement, typically not legally binding, that outlines most of the key terms and conditions of a contractual relationship, which forms a basis for the negotiation of the final transaction documents. After agreeing on each idea outlined in the term sheet, the parties (with the assistance of their lawyers) will enter a legal, binding relationship usually expressed as a share purchase agreement, investment agreement, or loan document, but there are many steps prior to closing and receiving actual funds.

Typical steps to negotiate most transaction agreements usually involves at least the following steps: (1) letters of intent,[1] (2) confidentiality agreements,[2] (3) term sheets, (4) due diligence,[3] and (5) final investment agreements. This section will focus on term sheets, explaining some of the major considerations for negotiating and drafting a term sheet and providing model examples appropriate for East Africa.

Within a term sheet, there are typically separate items that relate to what are called "commercial" vs "control" terms. Commercial terms refer to the expected financial offer & returns the investor can expect. Control terms refer to the key business decisions where the entrepreneur can expect the investor to participate in the decision-making. Most entrepreneurs and investors focus on the commercial terms – if they cannot agree on a financial offer, there is little point discussing further. However, both the entrepreneur and the investor should be just as careful when agreeing to control terms, as these govern the operations of the business. In this guide, we focus on common control terms to provide example language that has been used in East Africa.

NEGOTIATING A TERM SHEET IN EAST AFRICA

Discussing a term sheet is often the first time that both parties are negotiating concrete items that are written in formal language. Often in East Africa, entrepreneurs expect to agree on terms verbally which are then drawn up in formal legal documents and term sheets are a relatively new tool introduced from the West that many entrepreneurs have

[1] A letter of intent is a statement that documents the parties' intent to negotiate an agreement. It contains basic facts of the transaction, such as the names of the parties and expected compensation. It will often also contain an expected timeline within which the parties plan to finalize the agreement. The letter of intent is not legally binding, but does assure some expectation that both parties will negotiate in good faith.

[2] Confidentiality agreements formalize a promise by the parties (or one party) not to share information learned during the negotiations with third parties, and thus to maintain the confidentiality of, information provided to them. They are also known as non-disclosure agreements (NDA).

[3] Due diligence, in the context of an investment, indicates the investigation of the investment target that allows prospective investors to understand the business of the proposed investment, its markets, customers, financial condition, legal position, and any other risks or uncertainties inherent in the business. It typically will cover the financial, managerial, and strategic position of the proposed investment, macro-economic and regulatory environments, and industry/competitive landscape.

not used before. It is important that both the entrepreneur and investor view the term sheet as a draft document to be negotiated rather than the final offer, and both sides should have an explicit conversation about the entire process for negotiation to ensure that appropriate expectations are set.

Beyond using a term sheet for the first time, many entrepreneurs in East Africa expect to be able to negotiate a deal with the person they speak with first. However, many investment funds, especially international investment funds, require several rounds of iteration before any specific terms can be agreed upon. In the typical structure, the investor will have a portfolio associate meet with the entrepreneur first and conduct initial due diligence. From the point of view of the entrepreneur, they often view this first contact as the most important one and it is important to communicate the level of authority and decision-making ability that this person may or may not have, given more senior relationships within the fund. Especially when these representatives from senior management, senior counsel, or the investment committee are based abroad and "faceless" from the perspective of the entrepreneur, it is critical to explain their role in the process and to help the entrepreneur understand the full entity that is making the investment and commitment to their business. In East Africa, entrepreneurs may feel that these initial interactions with the investment team comprise a "hand shake" relationship and can be frustrated when different terms are required by different senior members of the fund, many of whom the entrepreneur will never meet, especially when it comes to senior counsel and investment committee members who often have the final say on specific terms and the language used to describe them.

ADJUDICATING ISSUES ARISING FROM A TERM SHEET

Though a term sheet is not a binding structure, there can be disagreements over specific terms or the language used to describe them throughout the negotiation process. This can be especially complicated when working with multiple levels of staff for international investments, where many of the team members are often based abroad. Oftentimes, the staff on the ground will be responsible for clearly communicating the rationale for requests coming from the senior team abroad, even when these might contradict agreements made with the entrepreneur earlier. It is important to resolve these disputes calmly and with the full understanding from both sides. The business world in East Africa revolves around established relationships that are in some cases able to influence the outcome of a conflict – entrepreneurs are likely to approach international investments in much the same way as local ones, but investors may not have the same local social recourse available.

Because the term sheet is not binding, disputes do not usually require outside mediation or resolution. However, disagreements can frequently lead to an end of the investment opportunity – for small changes, this may not be worth it for either the investor or the entrepreneur. As some might say, it's "important to pick your battles" and ensure good communication throughout the investor team to make sure that all expectations that have been promised to the entrepreneur have been met. Unfortunately, a bad relationship with the entrepreneur will often turn into a bad investment regardless of the terms actually signed.

For additional information on appropriate adjudication terms to including in legally binding documentation, please see the ANDE Legal Working Group Legal Guide section on arbitration and adjudication.

MODEL TERMS

In general, most of the important sections of a term sheet can be separated in two categories: commercial terms and control terms. Commercial (or financial) terms dictate how much return the investor should receive given a variety of potential outcomes for the company and any of the terms that have a direct impact on the investor's return in one of these potential outcomes. Control terms refer to ways in which the investor, company, or future investors may influence the direction of the business such as veto rights, board representation, restrictions on future share transfers, or any other action that the company might like to take while the investment is in place.

The language in this guide is meant to be neutral between the investor and the entrepreneur unless otherwise noted and is based on common practices in East Africa. When negotiating your own term sheet, any language should be tailored to the specific needs and circumstances of the deal, working closely with qualified counsel. It is especially important that both the investor and the entrepreneur fully understand the terms being agreed and how what is written in the term sheet translates to the final documentation. Many entrepreneurs in East Africa have not had the chance to work with counsel before and may benefit from an encouraging word to seek counsel rather than attempting to understand the documents on their own, which may be confusing to non-legal minds. In the long run, this helps to build a much stronger, positive relationship.

Entrepreneur's Perspective:
Preference shares can make it clear who has rights beyond the common shares, but it's important to understand when those rights (e.g. can the investor sell his preferred shares?). These shares must be registered specifically as preference shares with the Registry of Companies. Companies in East Africa are typically able to .

This guide will focus on control terms that dictate how much influence each party to the deal will have over common decisions many companies need to take in the course of business.

PARTICIPATION AND LIQUIDATION PREFERENCE

When investors purchase equity from a company, they will usually be interested in *preferred shares* as opposed to common stock. Preferred shares come with a bundle of extra rights negotiated during the investment process. From the entrepreneur's point of view, they might rather have investors keep shares of common stock – this puts investors and entrepreneurs on the same footing, though investors can still negotiate preferred rights (even on common shares) that might be attached to a seat on the Board of Directors or as a veto requiring their own specific approval. Getting investors to purchase common shares does not mean that all shareholders will have the same rights. Typically, investors will be looking for provisions that give them greater claims to stocks and assets, better access to dividends by contract, and veto rights. Almost always, these special rights will also include a liquidation preference, which determines the order in which assets are distributed in the event the company winds down and is able to recover some of the paid up capital through sale. In East Africa, preference shares can receive rights to a fixed dividend paid before the company distributes common dividends, though this is extremely favorable to investors and does not make sense for many entrepreneurs. Any type of fixed dividend can dramatically change the expected return for preferred shareholders vs common shareholders.

The liquidation preference often refers to two separate provisions: the liquidation preference and the participation rights.

Actual Preference

The preference states that if a company liquidates (sells all shares/assets, gets bought out, goes bankrupt, etc.), the investor gets their original investment back multiplied by an agreed upon amount. At the time of liquidation, the investor will have the option to divest their shares and take this preference or to convert the preferred stock to common stock and take the same distribution as common shareholders.

> **Investor's Perspective:**
> It is always better to have a liquidation preference, but it is extremely unfriendly to propose more than 1x original investment as the liquidation preference. Companies in East Africa are typically able to agree on a non-participating liquidation equal to 1x purchase price.

Typically, the preferred share holder will receive this preference before any distributions are made to the common stock holders, but after debts are paid. A simple pay-out upon liquidation will occur in the following sequence:

Debt → Preferred Shares B → Preferred Shares A → Common Stock.

Example language for the liquidation preference is below.

Example Language:

Liquidation Preference*: In the event of any liquidation, dissolution, or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of the Common Stock a per share amount equal to one times (1x) the Original Purchase Price plus any declared but unpaid dividends (the Liquidation Preference).*

In the example language above, the preferred shareholder will have the option of receiving 1x the original investment made or to convert their shares to common stock and receive the same payout as the common shareholders. This language is investor-friendly as in the event of liquidation, the investor is able to recover their initial investment before any other shareholders recover assets.

Consider, for example, an investor who invested $200,000 into Company XYZ for 25% of the shares ($800k valuation). If Company XYZ is then fully acquired for $1M, the investor must choose between keeping his preference or converting his preferred shares into common stock. If the investor keeps the preference he will receive $200,000 (1x the original investment). However, if he converts his shares, he will receive 25% of $1M, or $250,000. Clearly, converting to common stock is more beneficial. However, if Company XYZ does not have a higher sale valuation, and is sold for only $500,000, then the investor benefits from keeping the preference ($200,000) versus converting to common stock (25% of $500,000 = $125,000). In this example, the remaining shareholders who hold 75% of Company XYZ would divide $300,000.

PARTICIPATION

Beyond the actual preference, there will also be a provision for "participation" in the event of liquidation or winding up. This provision dictates whether, and to what extent, the preferred holders are able to convert their preferred stock to common stock and *participate* in the pro rata distribution of assets based on their common stock holdings. This means that, in some situations, the preferred shareholder will be able to obtain their liquidation preference (a multiple of the original investment) and also claim their share percentage of common stock earnings. This is obviously very advantageous to the investor, and it is appropriate for entrepreneurs to push back on this type of provision.

There are typically three versions of participation:

- *Non-Participating*: Investor has to choose between getting Series A Preference or participating just like any other common stockholder. This is most common in East Africa.
- *Full-Participation*: Investor receives their preference payment and participates fully, earning their share of liquidation payout after sale
- *Capped Participation*: Investor receives preference payment and participates up to a certain limit that is often set as a specific dollar amount

Any language to describe participation should be in the same section as the liquidation preference clause itself. These rights are typically negotiated simultaneously between the investor and the entrepreneur and are attached directly to the preference shares.

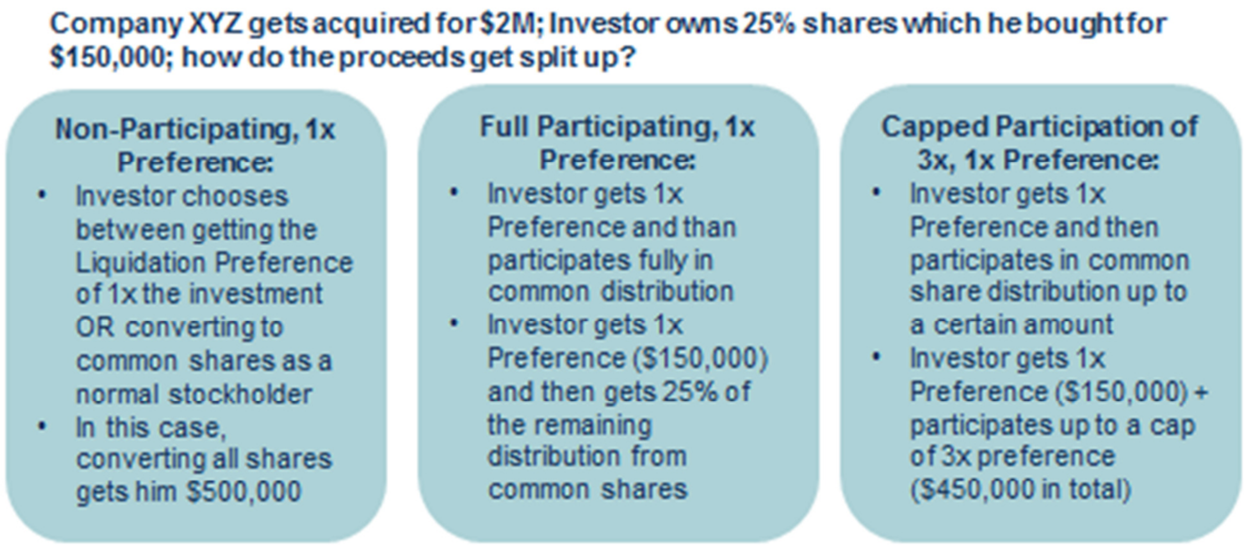
Example Language:

Full Participation*: After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed pro-rata to the holders of the Common Stock and the Series A Preferred on a common equivalent basis.*

OR

Capped Participation: *After the payment of the Liquidation Preference to the holders of the Series A Preferred, the remaining assets shall be distributed pro-rata to the holders of the Common Stock and the Series A Preferred on a common equivalent basis; provided that the* *holders of Series A Preferred will stop participating once they have received a total liquidation amount per share equal to 3x times the Original Purchase Price, plus any declared but unpaid dividends. Thereafter, the remaining assets shall be distributed ratably to the holders of the Common Stock excluding the holders of Series A Preferred shares.*

For some examples of how a liquidation would work under all three options, see below:



It is important to remember that under both non-participating and capped participation, the investor always has the option of converting the preferred shares into common stock. Thus, in the example above, an investor with a capped participation provision would be better off converting his 25% of shares into common stock ($500,000 vs. preference capped at $450,000).

From the entrepreneur's perspective, offering a non-participating liquidation preference to an investor can be used as a negotiating tactic to ensure that the rest of the term sheet is reasonably friendly to the entrepreneur and common shareholders. This protects the investor in the unlikely event that the company is unsuccessful, but in the far more likely event that the company is successful, the company will increase in value which will mean that the investor will most likely convert to common shares and participate on an equal footing with the holders of common stock in the event of a sale. Offering more than a non-participating liquidation preference is a substantial benefit to the investor and should be negotiated in conjunction with other terms that are important to entrepreneur to ensure that the overall term sheet results in a fair and balanced deal. Fair and balanced term sheets are what lead to strong, long-term relationships and solid businesses – over the long run, this is what leads to good returns for both the investor and the entrepreneur.

VETO RIGHTS AND PROTECTIVE PROVISIONS

Although preferred shares technically do not come with any voting rights, investors will typically demand some form of Veto Rights or Protective Provisions in order to ensure that they are part of key company decisions, especially those that might affect their investment returns. These rights protect the interests of investors so that any major decision or change in the company, as enumerated in the list of protective provisions, must be approved by the preferred shareholders. This can, in effect, create a "super board" which has the ability to control decisions taken by the standard Board of Directors. Sample language for typical protective provisions are below, but note that most of these are negotiable. There are many provisions that are considered standard in East Africa – it is extremely unlikely that an investor will be willing to invest without taking any protective provisions. The following protective provisions are seen as fairly standard and non-controversial:

Entrepreneur's Perspective:
When thinking about benefits such as veto rights or board representation, insert a minimum threshold of shares preferred shareholders must hold (e.g., 10% of fully diluted equity) to exercise veto rights. This prevents a preferred shareholder from selling most of their shares but holding onto a nominal amount in order to wield the voting power of these rights.

- A sale of the company or other "liquidation" event
- Amendments of the company's bylaws that alter the rights of the preferred stockholders in a negative way
- Any change in the total amount of preferred or common stock
- Any change in the number of directors for the company

Often, a provision similar to section (ix) in the example language below will be raised during negotiation, depending upon the size of the business. Many investors are conscious of the amount of debt the company takes on because it affects the overall value of the company and their ability to recover returns – this financing can be expensive for the company and taking on additional debt can signal that the company is not meeting projections. Each financing deal will be different, and the specific veto rights an investor asks for will change with each deal. In any case, protective provisions will never prevent the company from making critical decisions but rather stipulate that the investor must approve these business decisions. In a well-formulated deal backed by a strong relationship, both the entrepreneur and the investor should both be interested in doing what is right for the success of the company.

Investor's Perspective:
Sometimes investors will rely on board representation and veto rights to protect their interests, but remember that the board has fiduciary duties to the company. The board member has a legal duty to do what is in the best interest of the company, not the investor. If the Directors do not act in the best interest of the Company, there may be legal repercussions, which could have unintended consequences in East Africa.

Example Language:

***Protective Provisions**: For so long as [any/number/percent] shares of Series A Preferred remain outstanding, consent of the holders of at least a majority of the Series A Preferred shall be required for any action that, either directly or indirectly by amendment, merger, consolidation, or otherwise, (i) changes the authorized number of shares of Common or Series A Preferred, or increases the rights or preferences of any series or class having rights or preferences that are* *junior to the Series A Preferred so as to make the rights or preferences of such series or class equal or senior to the Series A Preferred; (ii) creates any new class or series of shares having rights, preferences or privileges senior to or on a parity with the Series A Preferred; (iii) results in the redemption or repurchase of any shares of Common Stock, unless pursuant to agreements with [employees, advisors, officers, directors, consultants, and service providers] of the Company that have been previously approved by the Board of Directors; (iv) results in any merger or consolidation with, or into, another entity, sale of control, or any transaction in which all, or substantially all, of the assets of the Company are transferred to another entity; (v) amends or waives any provision of the Company's Certificate of Incorporation or Bylaws in a manner which would be materially adverse to the holders of the Series A Preferred; (vi) increases or decreases the authorized size of the Company's Board of Directors; (vii) pays or declares any dividend on any shares of capital stock prior to the Series A Preferred; or (viii) creates or authorizes a debt obligation in excess of $100,000.*

<u>DRAG-ALONG RIGHTS</u>

Drag-Along rights give majority or preferred stakeholders the right to force minority stakeholders to sell their shares in case of an acquisition or other liquidity deal. Potential buyers of a company will not buy a company unless they are assured 100% of the company. If 5% of the shareholders refuse to sell their shares to a third party buyer, a small but stubborn minority of shareholders may be able to hold up a potentially lucrative deal for the majority of the company. This right is usually negotiated separately from other protective provisions, and is considered a much stronger right than the common rights listed above.

However, investors often view these provisions as a necessary security to ensure their ability to exit their investment, particularly if the company does not meet performance expectations or if a significant portion of the sale proceeds will be taken up by liquidation preferences given to one or more investors. Entrepreneurs will often find these terms restrictive and argue that, at least, the drag-along threshold should be 2/3 of the preferred shares, not a simple minority (or the trigger should be tied to common shares, *see sidebar*). Unless the Series A Preferred shares comprise a significant portion of the company, drag-along rights are typically associated to the combined value of Series A Preferred and Common Shares, which means that at least some of the shareholders that comprise part of the original founding group would need to agree to the sale. Throughout all control terms, these voting dynamics should be considered carefully, especially if there will be multiple equity rounds

Entrepreneur's Perspective:
Some drag-along provisions state that if a majority of the *Preferred A* shareholders agree to sell the company, then the *Common* shareholders will be dragged along with the deal. In this case, the compromise position will be to tie the drag along to a majority of *Common* stock, not *Preferred*.
In this situation, common stockholders only get dragged if a majority of the common decides the deal is good for the company. At the same time, if the preferred stockholders want to push the deal through, they will be forced to convert to common stock to gain the majority, thereby reducing any other privileges that might have been attached to preferred shares.

that further dilute original shareholders and early investors. Entrepreneurs can also push for a minimum sales price (e.g., 2x liquidation preference) to prevent the entire proceeds from being distributed to those holding shares with a liquidation preference. The interaction of these rights can be complicated, but often determine the total return for the investor and what remains for the entrepreneur or original shareholders. Of course, investors are much less likely to agree to a minimum sales price where the perceived risk of the company is high, but negotiating these dynamics can be a good tactic to reduce the potential impact from a liquidation preference during a sale, which most investors will not be willing to give up.

Example Language:

Drag-Along Rights: *The holders of the Common Stock shall be required to enter into an agreement with the holders of the Series A Preferred that provides that all such holders of Common Stock and the remaining holders of the Series A Preferred will vote their shares in favor of a transaction in which [%] or more of the voting power of the Company is transferred or any other Deemed Liquidation and which is approved by the holders of [%] of the outstanding shares of Series A Preferred, on an as-converted basis.*

OR

Drag-Along Rights: *So long as the Investors own shares of Series A Preferred Stock representing at least 25% of the Company's Common Stock on a fully-diluted basis, the Investors shall have drag-along rights with respect to securities of any of the Founders or principal Common Stock holders in the event of a proposed sale of the Company to a third party.*

Regardless of what percentage is chosen, it is important that the term sheet specifies what the conversion basis from Preferred Stock to Common Stock entails. Sometimes, investors will structure deals where each share of Series A Preferred converts to more than 1 common share. This can change the dynamics in each of these rights considerably – giving the investor additional power after conversion. Typically, Series A Preferred shares should convert to an equivalent number of common shares to avoid confusion. These dynamics are especially difficult for less-experienced entrepreneurs to understand, and could result in an adverse relationship in future even if it may seem like an easy way to negotiate additional power for the investor in the short-run.

If the company's founding team does not intend to sell their shares during an exit, they should be especially careful negotiating the percentages where drag-along rights would apply as these can force a total sale of the company. Investors will often push for these rights to prevent a very small minority shareholder from blocking an acquisition that is beneficial to the company and their returns, but depending on the structure of the founding team they may want to retain control over this type of sale.

TAG-ALONG RIGHTS OR CO-SALE AGREEMENT

Tag-along rights or Co-Sale Agreements are similar to Drag-Along rights. Essentially, the provision states that if any specific shareholder of the company decides to sell his or her shares in the company to a third party, that third party must also agree to buy a pro rata portion of another set of shares as well. This can be structured on either a majority or minority stake so long as it is specified clearly in the final deal documents, though it is typically only applied to majority shareholders. Often, a decision to invest equity in a company depends largely on the character of founders and management (which is why investors will also frequently demand vesting agreements or restrictions on the sale of shares for a period). Investors buy equity because of the competence of the current management and may not want to retain their investments with a change in ownership. The Tag-Along rights prevent founders or management from cashing out and leaving the investor with an entirely different management team. Investors do not want to be stuck with partners they did not choose. These rights ensure that if certain shareholders or a majority of shareholders intend leave the company, the investors also have an easy exit.

Example Language:

Tag-Along Rights: *Investors also shall have the right to participate on a pro rata basis in the event that [any / a portion] of the shares of Preferred Stock or Common Stock are transferred to a third party.*

OR

Tag-Along Rights: *Before any Majority Shareholder may sell Common or Preferred Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.*

OR

Tag-Along Rights**:** *Prior to any Shareholder exercising and consummating the sale of shares to any third party purchaser, Preferred A Shareholder may exercise its right to tag-along, part or whole of its shareholding, on a fully diluted basis, with that Shareholder on terms no less favorable than those offered to the other Shareholder.*

In the event Preferred A Shareholder exercises its tag-along rights as per the terms of the Agreement, the Shareholder shall not be entitled to transfer its shares in favor of any third party purchaser unless such third party purchaser has agreed to purchase all (but not less than all) the shares tagged along by Preferred A Shareholder in exercise of its right, which shall not jeopardize Preferred A Shareholder's right to sell its shares independently to the third party purchaser at similar terms and conditions in relation to price per share.

It is also possible to set limits for how many shares may be tagged for sale, but investors strongly prefer the option for a total exit. This can be used as a negotiating tactic for entrepreneurs where they are able to achieve more favorable terms elsewhere in exchange for accepting tag-along rights, which will limit their ability to sell shares before the investor.

ANTI-DILUTION PROVISIONS

Beyond the right to exit through drag / tag provisions, investors will often look for the option to preserve their shareholding in future rounds. Investors buy into a company at a certain valuation and price per share expecting that the value of each share will increase and that their investment value will also increase. However, if in a subsequent round of financing, new shares are issued at a valuation that is lower than the original investment (a "down-round"), then the original investors share value will decrease (also known as "dilution"). To prevent this, investors will often demand anti-dilution provisions. The anti-dilution provision adjusts the conversion price of preferred stock so that the value of the investor's stock upon conversion is not decreased dramatically. These types of clauses should be negotiated extremely carefully as they can dramatically change the dynamics between holders of Series A Preferred and Common shares if the value of the shares decreases.

For example, imagine that a Series A investor purchased 100 shares at $10/share (value of $1,000) for 25% of the company, then a Series B investor purchases shares at $5/share. Absent an anti-dilution provision, if the Series A investor now converts the 100 shares of preferred to common stock, the value of the investment will only be $500 (much less than the original investment of $1,000). If however, there is an anti-dilution provision in place, the investor will be able to convert his original investment of $1,000 to common stock shares at the new price of $5/share not the original $10/share. In this case, the investor receives 200 shares at $5/share and retains the original value of investment at $1,000. This is why this should be carefully negotiated – the Series A investor ownership can increase dramatically as a % of the total company shareholding, which may then give investors substantial power under other rights.

> **Investor's Perspective:**
> While the full-ratchet provision is most beneficial to investors from a share value standpoint, it can severely dilute the shareholder interests of your founders and employees. This can easily lead to soured relationships between the investor and the company as well as low incentives for the company to achieve success – in effect, this punishes the founding shareholders twice. Once when the company loses value and again when investors now own a larger % of the company. The weighted average has become fairly standard now.

FULL-RATCHET VS. WEIGHTED AVERAGE

Anti-dilution provisions are usually either "full-ratchet" or "weighted average." The above example is full-ratchet, which means that the sale of any number of shares (even one) at a lower price will trigger the anti-dilution adjustment to the conversion price. This is particularly beneficial to first investors, but potentially dilutive to future investors. In the above situation, the Series A investor starts with 25% of the company (100/400 shares). If the company only issues 10 shares at $5/share, under a full-ratchet anti-dilution provision suddenly the Series A investor is able to convert to 200 common shares and now holds nearly 49% of equity (200/410 shares).

Most anti-dilution provisions have shifted toward using the weighted average formula for calculating the adjusted conversion price. *See the example language below for the formula*. Using a weighted average formula, the new Series A conversion price is only $9.78, and thus the Series A investor could convert to 102 shares which does not have as dramatic an effect on total ownership. It is very rare to see term sheets with a full-ratchet, and entrepreneurs should negotiate hard against this method. For investors that begin by suggesting only aggressive investor-friendly terms like this, entrepreneurs are well-advised to look elsewhere.

NARROW-BASED V. BROAD-BASED

A second consideration when drafting anti-dilution provisions is how to define the number of shares of common stock outstanding. A broad-based anti-dilution provision will include (1) all the current common stock outstanding (including convertible preferred stock) as well as (2) the number of shares which could be obtained by exercising all options, securities, rights, or any other mechanism to convert to common stock. A narrow-based provision will not include the second portion (securities, options, ESOP) when calculating the common stock outstanding.

STEP UP OR LOSE YOUR ANTI-DILUTION RIGHTS

Many anti-dilution provisions include "carve-out" sections which exclude investors from the benefits of anti-dilution under some conditions. Several common carve-outs are included in the example below. Of particular note, the last carve-out states that investors lose anti-dilution benefits with regard to "shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their anti-dilution rights." This provision may be exercised when minority investors decide not to invest in a subsequent round of financing. For example, if the majority of preferred shareholders still inject additional capital in a subsequent round of financing, the minority shareholders who do not purchase any shares still benefit from the anti-dilution provisions. In this situation, the majority shareholders may vote to waive anti-dilution rights for this round of financing, which then encourages minority shareholders to actually participate in the financing and prevents the company from suffering additional dilution from shareholders who were not actually putting in more capital.

Example Language:

Anti-Dilution: *The conversion price of the Series A Preferred will be subject to a weighted average adjustment to reduce dilution in the event that the Company issues additional equity securities at a purchase price less than the applicable conversion price. This does not apply to (i) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board; (ii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement, or debt financing from a bank or similar financial institution approved by the Board; and (iii) shares with respect to which the holders of a majority of the outstanding Series A Preferred* *waive their anti-dilution rights. A Preferred conversion price shall be adjusted in accordance with the following formula:*

*CP2 = CP1 * (A+B) / (A+C)*

CP2 = Series A Conversion Price in effect immediately after new issue

CP1= Series A Conversion Price in effect immediately prior to new issue

A= Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding Common Stock, all shares of outstanding Preferred Stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)

B= Aggregate consideration received by the Company with respect to the new issue divided by CP1

C = Number of shares of stock issued in the subject transaction

BOARD REPRESENTATION

The board of directors is one of the most tangible ways investors can exercise control over a company. A representative on the board gives the investor a voice in major company decisions and provides a liaison between the company and investors. Establishing the board of directors is a relatively straightforward process, and most investors will want at least one representative on the board, whether that board member represents a single investor or the preferred shareholders as a group.

In determining the size of the board, investors and the company must balance between efficient management of the company and ensuring representation of all interests. Many decisions that the company takes requires only the approval of the Board of Directors rather than a vote by shareholding – this can change the voting dynamics substantially. As the board gets larger and more voices are included, companies must gain the consensus of more members to push through important decisions. Though countries in East Africa require specific individuals to be named to the Board of Directors, investors often want to ensure that they maintain control of their allotted seat even if that specific individual leaves the investment company. This needs to be specified in the investment documents, along with a procedure for the Investor to nominate a new member of the board. This new individual must be approved by the remaining Board of Directors, so often investors will require this to be a decision taken by the Series A Preferred shareholders only. So long as this only applies to the replacement of the seats allotted to the Series A holders, this is a relatively benign right for entrepreneurs to give to their investors.

In addition to the typical board representative, some investors may also ask for a non-voting board observer which allows the investor to stay involved in the happenings of the company but will not change the voting dynamics on company decisions.

Example Language:

Board of Directors*: The size of the Company's Board of Directors shall be set at [#]. The Board shall initially be comprised of [Name], as the Investor representative[s], [Name], [Name], and [Name]_. At each meeting for the election of directors, the holders of the Series A Preferred, voting as a separate class, shall be entitled to elect [#] member[s] of the Company's Board of Directors which director shall be designated by Investor, the holders of Common Stock, voting as a separate class, shall be entitled to elect [#] member[s], and the remaining directors will be [mutually agreed upon by the Common and Preferred, voting together as a single class/chosen by the mutual consent of the Board of Directors].*

OR

Board of Directors: *The Board shall be limited to [#] persons in total.*

At each meeting for the election of directors, Investor will have the right to nominate one, non-retiring, non-executive director to the Board of Directors.

In addition to the Investor's director, the holders of the Series A Preferred (including Investor) voting as a separate class, shall be entitled to elect [#] members of the Company's Board of Directors .

The holders of Common Stock, voting as a separate class, shall be entitled to elect [#] members.

The [#]th director will be mutually agreed upon by all shareholders voting together as a single class. The board of Directors will be held at least [#] times per year.

Entrepreneur's Perspective:
It is typical in East Africa for the CEO of the company to sit on the Board of Directors and often act as the Chairman of the Board, though this is not always the case.

Any further increase in the number of members in the Board will require prior written consent by holders of Series A Preferred. The Board will unanimously appoint a chairperson of every meeting of the Board of Directors, and such chairperson will have a casting vote.

PAY-TO-PLAY

Under Pay-to-Play provisions, preferred shareholders must continue to participate in future rounds of financing in order to keep their preferred shares. If the shareholders do not participate, their preferred shares automatically convert to common stock or are subject to other penalties, such as losing anti-dilution benefits. On the face of it, Pay-to-Play appears to solely benefit the interests of the company and, in many ways, it does. However, this provision often arises when there are multiple investors in a single round of financing. An investor may want assurances that, if the company needs a further capital injection, all investors take part and support the company on a pro-rata basis so that a single investor of the

Entrepreneur's Perspective:
Some investors may balk at pay-to-play provisions, but founders are looking for investors who want to support the company for the long run. If there are certain investors who are clearly not expected to contribute further financing (like some angels or non-lead investors), appropriate carve outs can be drafted.

group is not expected to support future financing rounds while other members of the group are able to retain preferred rights on what becomes a small shareholding of the total company.

Two examples of Pay-to-Play are below. Notice that the severity of the Pay-to-Play provision may be adjusted by (1) changing the penalty associated (converting to common stock versus losing anti-dilution rights) and (2) only applying Pay-to-Play penalties to the pro rata share of equity not participating. Pay-to-play provisions are sometimes drafted so that they only apply to down-rounds or are waived during up-rounds of financing.

Example Language:

Pay-to-Play: *On any subsequent round of financing all Preferred Shareholders are required to purchase their pro rata share of the securities set aside by the Board for purchase by the Preferred Shareholders. All shares of Series A Preferred of any Preferred Shareholder failing to do so will automatically [lose anti-dilution rights/lose right to participate in future rounds/convert to Common Stock and lose the right to a Board seat if applicable].*

OR

Pay-to-Play: *On any subsequent round of financing all Preferred Shareholders are required to purchase their pro rata share of the securities set aside by the Board for purchase by the Preferred Shareholders. If any Preferred Shareholder participates in the subsequent round of financing, but not to the full extent of its pro rata shares, then shares of Series A Preferred of that Preferred Shareholder equal to the pro rata share not contributed will automatically [lose anti-dilution rights/lose right to participate in future rounds/convert to Common Stock and lose the right to a Board seat if applicable].*

RIGHT OF FIRST REFUSAL

The Right of First Refusal (RoFR) is a fairly common term and often bundled together with the Co-Sale Rights. The RoFR requires the company, or shareholder, to offer an investor the right to purchase any shares prior to offering those shares to a third party. RoFR's are standard terms and are usually part of most deals, but there are still portions of this clause that are negotiable. First, the company can argue that there should be a threshold limit such that only shareholders who hold a certain percentage (e.g., 25%) of the shares can exercise the RoFR. This is sometimes convenient when you have a large number of minority shareholders and the Company does not want to extend the RoFR to all of them. Second, the investors and the company can implement a threshold for number of shares the investor can purchase. In the example below, the investor is able to purchase up its pro rata share of equity. A more investor-friendly version would have no limit on the number of shares purchase-able or cap the number of shares at a multiple of the pro rata. The pro rata share of equity is most common.

It is important to note that a company can also offer a RoFR to the founding shareholders or entrepreneur to facilitate management ownership in future rounds. This type of structure is often combined with a financing plan for management to inject appropriate capital as this can facilitate an exit for investors. Entrepreneurs also have the option to suggest a preferential price or discount to the prevailing price to allow management to re-purchase shares of the company. This is often a good term for entrepreneurs to negotiate in exchange for some of the limits investors may desire on transfers of shares.

Example Language:

Right of First Refusal: *In the event that the Company or a holder of Series A Preferred proposes to offer equity securities to any person, current shareholders holders shall have the right to purchase their pro rata portion of such shares. [This does not apply to (i) shares issued for consideration other than cash pursuant to a merger, consolidation, acquisition, or similar business combination approved by the Board; (ii) shares issued pursuant to any equipment loan or leasing arrangement, real property leasing arrangement, or debt financing from a bank or similar financial institution approved by the Board; and (iii) shares with respect to which the holders of a majority of the outstanding Series A Preferred waive their right of first refusal.]*