

Yes, Governance Matters.

August 02, 2024

TERM SHEET TACTICS: VCS STEERING START-UP GOVERNANCE

- Term sheets outline the basic terms of investment transactions, setting expectations for governance.
- VCs now insist on stricter governance rights due to increased start-up competition and governance issues
- Negotiating a term sheet is a critical step in the investment process, serving as the foundation for the final investment agreement between the start-ups and investors

BACKGROUND:

In recent years, the start-up ecosystem has emerged as a catalyst for innovation and economic growth. Fuelled by entrepreneurial vision and often supported by Venture Capitalists ("VC"), start-ups play a key role in shaping industries and disrupting traditional business models. However, despite their tremendous potential for success, several start-ups are failing due to lapses in *corporate governance*.

In the context of start-ups, effective governance is essential, not solely for regulatory compliance but also to build trust among stakeholders, manage risks, and sustain long-term growth. Governance often serves as the foundation for start-ups to build credibility and attract investments. Investors, including VCs and institutional funds, prioritize transparency, accountability, and ethical conduct while evaluating potential investments. In an environment characterized by uncertainty, volatility, and an unbridled growth rate, robust governance frameworks provide stability and confidence to investors, thereby facilitating the capital infusion necessary for expansion and innovation.

Despite the imperative of sound governance, VCs frequently encounter governance lapses in the companies that jeopardize their credibility and viability. These lapses can manifest in various forms, including financial mismanagement, conflicts of interest, inadequate disclosure, and non-compliance with regulatory requirements. Several such instances have been seen lately in the Indian economy, wherein companies such as Byjus, BharatPe, DeHaat, Zilingo, GoMechanic have been alleged of indulging in several malpractices such as related party transactions,¹ fund diversion, falsified invoices,² undisclosed debts, inflated revenues, non-transparent accounting practices and internal corruption.³ Such malpractices eventually lead to failures of the start-ups, attracting legal and reputational risks and thereby, undermining the confidence of the investors.

GOVERNANCE DURING TERM SHEET NEGOTIATIONS:

The prevalence of governance failures in start-ups necessitates a proactive approach to address underlying vulnerabilities and promote a culture of governance excellence. Regulatory frameworks serve as benchmarks for governance practices, guiding start-ups in adopting policies that align with industry standards and best practices. Furthermore, establishing a diverse and independent board of directors is crucial for effective oversight and decision-making. Independent directors bring diverse expertise and perspectives, reducing the risk of conflicts of interest and enhancing governance credibility.

In response to discovering shortcomings in the companies late in the investment cycle, resulting in losses, VCs now negotiate various rights and powers early on, during the term sheet stage. A *'term sheet'* is a non-binding legal document that outlines the basic terms and conditions of an investment transaction between two parties - typically between an investor and a start-up seeking funding. A term sheet plays a crucial role in the negotiation process. It allows both parties to establish an understanding of key deal points before investing time and resources in detailed legal contracts and due diligence. Term sheet negotiations offer an opportunity to clarify VC's involvement in the business of the start-up and sets the expectations for all parties.

Negotiating a term sheet is a critical step in the investment process, serving as the foundation for the final investment agreement between the start-ups and investors. The term sheet outlines the key terms and conditions of the investment, including governance provisions that dictate how the company will be managed and controlled post-investment. In recent years, certain governance clauses have gained prominence due to evolving market dynamics, lapses in governance, regulatory changes, and the increasing complexity of start-up ecosystems.

Previously, the term sheets heavily favoured the founders as the VCs were eager to invest and as a result would only ensure there are sufficient clauses protecting their exit. However, with increased start up competition and governance issues leading to failures, investors now wield significant negotiating power by insisting for several rights, to an extent that they may walk away from the deals if their demanded rights are not met. We note that recently there has been a considerable delay in closing deals between the VCs and start-ups due to VCs' increased involvement in deal negotiations and alignment of interest with founders on the matters of governance. Few years back, VCs would insist only on minor rights such as observer seat, information rights, exit of the founders due to

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fraud, exit due to initial public offer or sale of shares by founders. However, recently the investors have begun to insist on inclusion of several rights in the term sheets, such as:

- Voting rights of the directors as against the observer rights demanded earlier.
- Expanded definition of '*bad leaver event*' – Earlier the VCs would insist for termination of the founder's employment and exit only if founders committed fraud, wilful misconduct or moral turpitude. However, lately, the definition of 'bad leaver event' is undergoing changes and being made comprehensive to include several reasons such as any criminal complaints against the founder, breach of investment documents, breach of non-compete provisions as a 'bad leader event'.
- Comprehensive modes and procedure of exit.
- Automatic renewal of the exclusivity period, if the same has lapsed due to the delays caused by the promoters/ company.
- Earn out/ deferred payment instead of upfront payment, depending on the growth of the company and milestones achieved by the founders. Some VCs also establish key performance indicators (KPIs) that are tied to governance and compliance metrics. Performance on these KPIs is regularly reviewed and impacts future funding decisions of such VCs.
- Inspection rights satisfactory to VCs, replacing earlier negotiated information rights.
- Appointment of independent directors, chief financial officer to oversee the functions and monies of the company and conducting independent audit by firms acceptable to the investors.
- Creation of audit and compensation committees to review salaries, especially of the founders and key managerial personnel, and compliance with global standards. Audit committee is also tasked with overseeing adherence to corporate governance norms, ethical standards, and regulatory requirements.
- Approval of the VCs for hiring of any key managerial personnel of the company and their tasks, responsibilities and salaries.
- Covenants by founders on compliance by the companies with global anti-corruption laws and environmental, social and governance norms.
- Disclosure of income sources of the promoters and their participation in other start-ups/ companies as mentors or directors. This includes insertion of explicit clauses addressing conflict of interest. Start-ups are now required to disclose any potential conflicts and have clear policies on how these will be managed.
- Undertaking rigorous due diligence instead of a high-level review of issues in the company and insistence on resolving all regulatory and legal issues prior to the closing of the transaction. This also includes periodic checks on compliance, financial reporting, and operational transparency.
- Emphasis on establishing robust ethics and whistle-blower policies.

CONCLUSION :

Corporate governance is paramount for start-up sustainability, investor trust, and operational integrity. Start-ups face governance challenges, including financial mismanagement, conflicts of interest, and inadequate risk management, which impact their viability and success. In addition to being vital for the operational stability and longevity of start-ups, robust corporate governance practices are equally crucial for VCs. As the start-up ecosystem continues to evolve, certain governance provisions have become increasingly relevant, reflecting the need for greater control, transparency, and alignment of interests between founders and investors. The binding nature of certain clauses, despite the overall non-binding declaration of the term sheet, requires careful consideration and strategic foresight.

Effective governance frameworks mitigate investment risks, enhance transparency in decision-making, and safeguard VCs' interests throughout the investment lifecycle.. As such, prioritizing governance excellence not only safeguards investor interests but also nurtures a thriving ecosystem where innovation can flourish, and businesses can scale responsibly.

However, VCs' increasing insistence on stringent governance standards has presented challenges for founders. Start-ups often struggle to balance investor expectations with maintaining operational autonomy. Excessive interference from VCs in day-to-day operations or strategic decisions can hinder agility and innovation, crucial for start-up success. Founders often spend time navigating complex governance requirements and compliance burdens, thus diverting attention from core business priorities. This dynamic can strain founder-investor relationships and, in some cases, lead to disagreements or the breakdown of deals. Therefore, while governance frameworks are essential for investor protection and sustainable growth, achieving a balance that respects entrepreneurial vision and encourages collaboration between founders and investors remains crucial for long-term success in the start-up ecosystem.

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You can direct your queries or comments to the relevant member.

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¹A funding winter's tale: Corporate governance failures hold many lessons for startups, accessible at <https://www.moneycontrol.com/news/business/startup/a-funding-winters-tale-corporate-governance-failures-hold-many-lessons-for->

²BharatPe Co-founder Faces Allegations Of Generating Fake Invoices, EOW Reveals, accessible at <https://businessworld.in/article/bharatpe-co-founder-faces-allegations-of-generating-fake-invoices-eow-reveals-499191>.

³Zilingo case: How a celebrity CEO Ankit Bose's rule of fear helped bring down hot startup Zilingo, accessible at <https://economictimes.indiatimes.com/tech/startups/how-a-celebrity-ceos-rule-of-fear-helped-bring-down-hot-startup-zilingo/articleshow/93335057.cms?from=mdr>.

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