DO YOU REALLY NEED A TERM SHEET?

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A term sheet – also known as an LOI (letter of intent) or MOU (memorandum of understanding) – is the first written document in almost every investment in a start-up. Before it, the company and the investors shake hands on the most basic issues: size of the investment, kinds of shares to be issued, valuation and composition of the board. A term sheet formalizes the handshake and provides additional detail about the deal.

A term sheet almost never binds the parties to do much more than maintain confidentiality, not shop the deal around and to negotiate in good faith (including providing and reviewing due diligence documents) towards a binding deal. Neither the start-up nor the investor is actually obligated to do the deal until the final documents are signed and the closing conditions are met.

Let's look at what a term sheet includes:

At the term sheet stage, the start-up and investor have almost always agreed already on the valuation of the company before the investment. Though occasionally such agreement expresses itself in an agreed price per share (say, when the investment closely follows another investment and the parties agree that the price per share will be the same as in the previous investment), most often, at term sheet stage, the valuation is expressed as a pre-money, fully diluted valuation of the whole company. For example, if the pre-money valuation is $15M and the investment is $5M, the investor will be entitled to 25% of the start-up. Fully diluted is not a term of art though. Does it include options that the start-up has authorized for award but not awarded? Will the investor require the start-up to "top-up" its un-awarded option pool prior to the investment? Are outstanding convertible loans that will convert with the investment part of "fully-diluted"? All of those points are dead center to the deal. The more that is included in "fully-diluted", the worse for the company.

What kind of shares will the investor get? Will it get preferred shares that give it the right to receive its investment back before any distribution to other shareholders and entitle it to anti-dilution protection if shares are ever sold at a lower price (and, just as with "fully-diluted" both of those possibilities have a lot of room for variation and negotiation) or will it get ordinary shares like the founders?

Will the investor be granted warrants to purchase shares later? Warrants can significantly sweeten a deal for an investor and, for just that reason, the start-up would rather not give them. To how many shares will the warrants relate? How long will they be valid? At what price can they be exercised? Yet again, each deal varies in these matters and each detail counts.

What rights will be attached to the investors' shares and will similar rights be attached to ordinary shares: rights to invest in later rounds before outside money is taken, rights to purchase the shares of other shareholders before they are sold to outsiders, rights to "tag along" when other shareholders sell their shares to outsiders? Under what circumstances can a group of shareholders force the other shareholders to sell their shares to enable an exit? If the company goes public in the US or other common-law country, are there circumstances in which the shareholders can force the company to register their shares to make them saleable on the stock exchange? Needless to say, here too there is a lot of room for variation and negotiation.

Who will be entitled to appoint the members of the board and how many will each appoint – a critical issue for ongoing control of the start-up? Will the investor – assuming it is acquiring a minority shareholding – be given the power to block various types of actions by the company if they are not to its liking, and what actions? Do we need to repeat the refrain?: there is a lot a wiggle-room on these issues.

Lastly, will the start-up commit not to shop the deal around while negotiations are going on? For how long? Are there exclusions? How will the due diligence process work? What will be the limitations on disclosure by the parties? What is the target date for signature of the final deal? Even here, wiggle-room abounds.

Now that we've seen that the term sheet is quite detailed and includes almost all the main points of the deal (though far from the level of detail included in the final documents), if most of it is not binding, why should a start-up bother with it? Why not just go ahead to the final agreements?

A term sheet does two things: it makes certain that the start-up and the investor see eyeto-eye on the main points of what is, after all, a complicated transaction and it allows the parties to establish that they see eye-to-eye before they engage in the complex and time-consuming business of due diligence and negotiating final agreements. It does both of those at a time in the negotiation process when the parties are fresh to the deal and have a lot of negotiating energy. Often, in the later stages of a complex transaction, the parties have spent so much negotiating energy that a previously unresolved issue can blow up a deal. If that issue is resolved at term sheet stage, that is far less likely to happen.

A term sheet doesn't guarantee that the deal will be concluded, but it makes the odds much higher.

Term sheets are a critical part of the process of successfully taking in an investment.

Usually, the investor presents the first draft of a term sheet following initial discussions, some rudimentary due diligence and a handshake. As you will have understood, a start-up can't deal with the negotiation of a term sheet by itself. It needs help from its lawyers. But even before term sheet stage, it's important for the founders to have a good sit down with their lawyers. That way, when they and the investor agree on the most basic issues, they will make the best deal they can for themselves and the term sheet that the investor will present will include that deal.