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INSIGHTS

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Negotiating a Term Sheet? Entrepreneurs, Take Note

Q: WHAT DO ENTREPRENEURS NEED TO KNOW ABOUT TERM SHEETS IN ORDER TO GET A DEAL DONE?

WILLIAM BERNAT: Term sheets are not "one size fits all." Since most of a term sheet's provisions are meant to protect the investors' investment, it's not uncommon for investors and founders to have vastly different expectations of what a deal will look like. Getting a signed term sheet is one of the biggest early milestones for a company to achieve, but it doesn't guarantee an investment—that comes only when the parties are able to agree on the definitive deal documents that spell out the specific provisions in the term sheet, among other matters. Founders need to understand that every provision in a term sheet is included for a specific reason and each generally works in concert with the others, meaning that modifying the terms in one section will likely have a rippling effect elsewhere.

Q: WHAT'S COVERED IN A TERM SHEET?

WB: A lot, all focused around four major themes—economics, management and control, investor rights and protection, and rights upon exit/liquidity. The economics of the deal are usually at the forefront, with the pre-money valuation being one of the hardest terms to reach agreement on. Investors generally want a big enough piece of the pie to justify doing the deal, to get paid back first in a down-side scenario, and to ensure future equity grants to employees don't dilute their investment. Term sheets also cover management and control issues, as investors want to participate in the decision-making process and control certain founder behavior; investor protections, so that investors can protect the value of their investment and prevent others from getting liquidity out ahead of them; and exit and liquidity, where investors want to ensure they have a way to get their money back in all possible scenarios.

Q: HOW CRITICAL ARE OPTION POOLS IN CONDUCTING NEGOTIATIONS AND HAMMERING OUT TERM SHEETS?

WB: Options and other equity incentives are the main way that early stage companies attract and motivate key employees, so investors will require a company to increase the number of shares available to be issued under the pool to a certain agreed-upon percentage (10 to 20%) to ensure that the company has the ability to do so. The negotiation isn't usually around the size of the pool, however, but rather whether the increase should be made on a pre- or post-money basis.

Q: OF COURSE THE ECONOMICS ARE IMPORTANT, BUT WHAT ABOUT THE BALANCE OF POWER?

WB: Valuation is important, but not *the* most important thing. Founders often focus too heavily on it, not understanding that a savvy investor may be able to "undo" most of what was gained through the valuation by modifying the other terms in the term sheet. Governance, management and control—where investors will receive certain contractual rights that can limit the founders' actions regarding major decisions arising during the company's lifespan—are also key concepts. Investors may have the right to approve a sale of the company or the issuance of future rounds of stock. The investor designee on the board of directors may also have veto rights with respect to certain types of transactions, like incurring debt or increasing executive salaries. These are all critical components of making a fair deal and important aspects of creating a workable term sheet.

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