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THE TERM SHEET IS ONLY THE BEGINNING

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Quick Summary: A term sheet is like the beginning of a wedding engagement, with many issues to discuss.

Abstract:

Throughout the fundraising process, the entrepreneur focuses on securing a term sheet from an investor. At the moment that one is received, there is a natural sense of accomplishment. That feeling is warranted; an investor has shown confidence in you and your plan. However, the term sheet is not the end; it is only the beginning of the commitment.

Finally, *at last*, you have received a term sheet from an investor. The months of hard work, disappointment, and investor rejections are behind you. An investor has finally understood the great opportunity that you have created and wants to join you in making your dream a reality. Not so fast! A term sheet is like an engagement ring you have received and accepted. It is a commitment that has been made, and you have accepted it. Both of you are planning for success and are looking forward to a long and mutually beneficial relationship. But the reality is that neither of you have walked down the aisle and said, “I do.”

The term sheet is a simple document covering only the deal's highlights. It may cover such things as the investment amount, percentage ownership, type of stock, liquidation preferences, and a few “other” items. In other cases, it may cover far more details, but it is still a summary document. Invariably, it will include a provision that states the term sheet does not constitute a contractual agreement. It only represents some of the terms that will be included in a purchase agreement negotiated and committed to by both parties. Therein lies the predicament. The purchase agreement, written by lawyers, will contain dozens of “minor details” which, in fact, will easily become major issues. It is a classic example of the old saying, “You set the price, I’ll set the terms.” Remember, investors and their legal counsels do term sheets and purchase agreements all the time. Understandably, their focus is to protect their interests and maximize every aspect of the transaction to their benefit. This approach is not an indictment or judgmental statement; it represents sound business practices on the investor’s part. The investors owe it to their limited partners, who have entrusted their capital to them with the goal of maximizing the partners’ returns.

Unfortunately, the “golden rule” applies: “He who has the gold makes the rules.” Obviously, finalizing the deal is far more important to the entrepreneur than it is to the investor, who probably has many

more opportunities waiting in the wings. Their logic is that if this investment opportunity does not work out, there are many more that they can pursue. Similar to the marriage engagement of a couple, once they are engaged, they stop looking for another partner. For company/investor situations, the agreement to stop looking after a term sheet is signed is less than equal. Although the investor may encourage the company to continue to seek other partners, the existing term sheet terms usually set the overall structure of the deal. Exhausted from the fundraising process, the company may, in fact, cease to look for other investors or may do so in only a half-hearted manner. The end result of the “golden rule” and the conscious or unconscious efforts to stop looking for other investors, the negotiating leverage clearly favors the investor.

It is imperative that the company retain legal counsel who has in-depth experience in representing other companies in similar transactions. When retaining a legal counsel, follow the principle that if you know you will have to catch your forward pass, you are likely to be more careful where you throw the ball. Retain the same law firm and attorney that helped negotiate the purchase agreement as the company’s ongoing legal counsel. This will help ensure that the purchase agreement provisions are fair, reasonable, and in the company’s best long-term interest.

Purchase Agreement negotiations can be contentious, stressful, and argumentative. They can generate a host of other equally negative feelings. It is very hard for the entrepreneur not to view these negotiations as personal and threatening. For the investor, who has been through this process many times before, they are nothing more than events in the normal course of business. In the majority of cases, once a term sheet is executed, the agreement on the purchase agreement occurs; perhaps after some anxious moments. Once completed, the agreement is typically put on the shelf. It is seldom referred to until something goes terribly wrong or remarkably well. Then, all parties will carefully scrutinize the value of contractual terms. The time spent upfront between the reception of the term sheet and the final execution of the purchase agreement will be time well spent. Only after the purchase agreement is signed and put on the shelf will the end of the beginning be complete.