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GROWTH PROGRAMS

6 Ways to Master the Term Sheet Process

What is a term sheet?

At the most basic level, a term-sheet is a non-binding contract that outlines the terms of an investment deal. A term sheet is meant to take all the items that a founder and investor have discussed and negotiated in terms of financing, governance, and investor rights and distill them into a couple of pages. From there, the lawyers can take the term sheet and expand them into a legal document that may end up being hundreds of pages long.

A term sheet is just an agreement saying, "Hey, I agree to want to work with you. I'm going to ask a bunch of people about you and do some diligence, but it's not going to be a month until we make this formal." - Caitlin Strandberg, Lerer Hippeau

Why do term sheets exist?

Venture capital investors receive money from people referred to as limited partners. These partners trust VCs with their capital, hoping that there will be a return on their investment. As such, when partners give this capital, investors agree to a handful of commitments and obligations that they will pay attention to where that capital goes. This involves putting restrictions, rights, and protections in place so a VC firm can protect that investment throughout the lifecycle of a company. Really, a term sheet is a list of rights and protections that investors have.

The term sheet is an opportunity for both parties to be aligned over certain elements, so both parties continue to have the same incentives to row the boat in the same direction, which is to build a very powerful and successful and massive business.

6 Ways to Master the Term Sheet Process


1. Familiarize Yourself with the Terms

1. Securities. The security being offered is essentially the type of equity that is being given to the investor. When it comes to venture capital, the security indicates the round that a given company is raising. If a company is raising its series A round the security will be called "Series A Preferred Stock."

2. Valuation. There are two valuations you need to be aware of. The pre-money valuation is what your company is worth before the investment and the post-money valuation is what your company is worth after the investment. More advice on how to think about your valuation in step 3 later on.

3. Liquidation Preference. In the event that the company either gets sold or liquidated, liquidation preference means the company's investors or the preferred stockholders get their investment back first. For example, let's say a company is sold for \$50 million and an investor has put in \$25 million with a 2x liquidation preference. This would mean that the \$50 million would all go to the preferred investor and the common shareholders wouldn't have anything left at that time.





4. Conversion. A conversion right is the right for an investor to convert shares of preferred stocks into common stocks. These come in two primary forms: mandatory and optional. Mandatory conversion would occur in the case of an IPO or a majority vote by the board. Optional conversion rights means that the preferred stockholder has the right to convert their preferred stock into shares of common stock at their discretion.

5. Dividends. The dividend section of a term sheet determines how a company's profits will be distributed among shareholders. These are typically paid in either cash or stock. There are three common ways that dividends can be structured and each is typically seen as being more beneficial to a different party at the negotiating table.

Cumulative dividends. These are the most valuable to those with preferred stock and least advantageous to those with common stock. The dividends accrue on the initial stock purchase price and are paid when the startup is liquidated or the stocks are redeemed. Cumulative dividends represent another way in which the preferred stocks are valued before common stock and thus reduce funds available to common stockholders.

Non-cumulative dividends. These are only paid on the preferred stock when/if the Board declares them on a given year. If they are not declared, then they do not accrue and the preferred stock owner's rights to the dividend are extinguished for that year. This is better for the common stockholders yet still has the potential to greatly benefit preferred stockholders.

Dividends on preferred stock only if paid on the common. This structure is the least advantageous for the preferred stock and most valuable to the common stock. In this situation, preferred stock is treated just like common stock when the dividend is declared and all parties share in the dividends as if all parties owned common stock.

6. Voting rights. This section covers which rights are granted to preferred shareholders to vote along-side the common shareholders. Often, there is a requirement that a certain percentage of stockholders need to approve certain actions via majority or supermajority. These actions might include authorizing the issuing of new stock, dissolving the company, or changing the board size

2. Figure Out What Is Important to You and What Isn't



As with any negotiation, there are likely to be certain points that you care more strongly about than others. That's why, before you even enter the negotiation process, you need to take time to learn what each of these terms mean, why they're important for your business and how they can affect your business. As a founding team, you need to figure out which points are important to you, which are important to your company, and which are just a standard set of terms that any VC is going to ask you for.

Trying to separate those that are standard terms that will play out in a normal way from those that are very business specific is an important exercise before you begin negotiation. It's important to remember that what will follow the term sheet is a business relationship, so you need to separate the business decisions from the personal feelings of "I'm just giving stuff up and I owned a 100% of this yesterday, so I don't want to give anything up."

When it comes to negotiating a term sheet, you want to think of the whole process holistically. Rather than thinking of a negotiation as one discussion on one point, then another discussion on another point you want to think: "What is this holistic agreement that I'm entering into? What is the interplay between valuation (for example) and this other clause in here?"

If you're going to negotiate certain points or ask about certain things, a good idea might be to practice is with your lawyer first, maybe talk about all the things that you want to talk about and get some advice and perspective from them. To an investor, the negotiation process is really a demonstration on how you are going to work with them and how they are going to work with you. If the investor feels like they are being taken advantage of and you feel like you're getting taken advantage of that's not a good thing.

3. How to Think About Valuation When it Comes to a Term Sheet

One part of the term sheet that can end up being pretty contentious and can require a lot of negotiation is the valuation of your company. We won't touch specifically on how to determine your valuation here (that's a whole different topic for another day) but rather how you should be thinking about your valuation in the context of your overall term sheet negotiation.

There are many instances where an investor's willing to give you a billion dollar valuation, then have other features in there like a three, four, five times liquidation preference to protect their down side. They may be believers, that, yes, if it's a home run, everybody wins, so everyone's happy, but if things go sideways or go down, then you really are not going to be taking advantage of that high watermark valuation. Many, many companies and many founders really get caught up in either being a unicorn or having your high watermark valuation, and they lose sight of the other terms that are equally important. Valuation is absolutely important, not the only thing to focus on.





A good deal is one where everyone's a little bit unhappy. You're generally happy, but you're a little bit unhappy and the best deal is a done deal. - Caitlin Strandberg, Lerer Hippeau

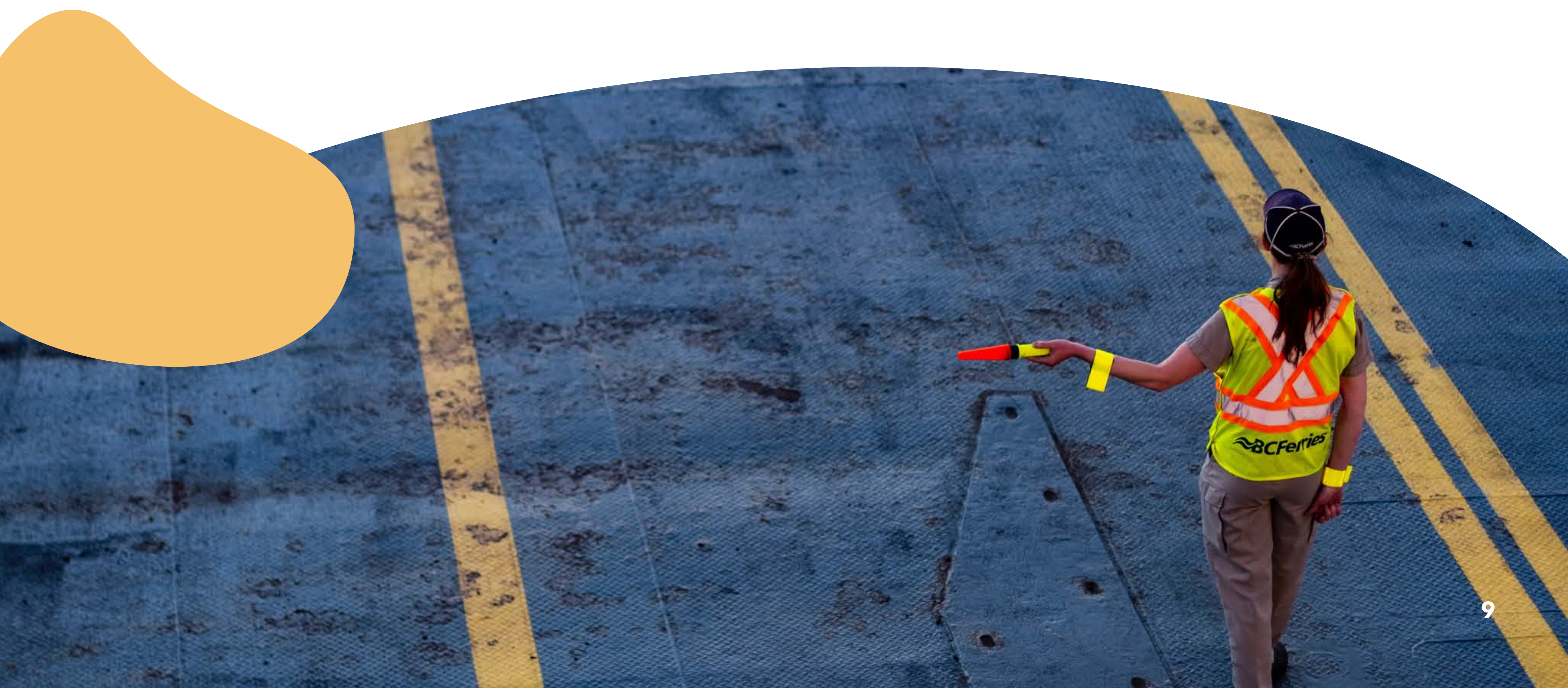
When it comes to your valuation, you should be thinking about when things go sideways. In the world of startups, it is inevitable that things will go wrong, you just don't know when. So, when you're thinking about your valuation, you need to find a number that you're comfortable with that if things go sideways, you can create more value than that number so you can raise it to a higher valuation in the next round. It's really detrimental for a company to go to a VC and want a very high valuation because the expectation is that they need to meet or exceed that within 18 months to raise their next round of financing. You want to find a number that is realistic and reasonable and you can effectively beat with the time that you have.


4. Look Out for These Red Flags

When you are going through the term sheet process you want to make sure that you aren't agreeing to anything that you will regret down the line. You want to make sure you are doing right by your company, your employees, your shareholders, and (of course) yourself. Particularly if this is your first time negotiating a term sheet, here are a few things that you want to look out for. Many of these red flags you can spot yourself if you are familiar with the terms themselves so make sure you study up on the terms in section one if you haven't already.

An aggressive liquidation preference. Holders of preferred stock should expect to receive at least the minimum market rate of a 1X liquidation preference. Any more than that, however, should require some serious consideration. While a 2X liquidation preference might seem like an easy consolation now, it might mean that you and your employees make nothing if your company sells for less than anticipated at a later time.

A review period. If an investor requests a review period (giving them the right to pull the term sheet after it's been signed) this is an indicator that they have not done their due-diligence. Typically, a term sheet should only be pulled after signing if the startup





has failed to truthfully report on financials, sales, revenue, etc to an investor. Term sheets should be issued after an investor feels confident in a deal and has done their business diligence, not before.

Too much board control. Sometimes an investor might want a bit too much control on your board. Don't hesitate to consult with others or your lawyer (more on that later) if you think an investor is trying to claim a bit too much board control.

Guaranteed exit. If there is a guaranteed exit specified in your term sheet you should be extremely wary of this investor. Startups are, by definition, unproven business models so legally committing to find a buyer for investors' shares within a given period of time is not a reasonable request.

Specified change in management. While a board always has the right to replace the CEO if they determine they are not fit to lead the company, this does not need to be outlined in the terms. Investors should not be looking to invest in a company where they want to get rid of the CEO soon after.



5. Get Yourself a Lawyer You Trust

What's the best way to make sure that you aren't agreeing to a bad term sheet? Getting yourself a lawyer you can trust. You want an experienced venture attorney who has seen a lot of term sheets, who you can send your term sheet to and say, "Hey, does this pass the smell test?"

If you're going out to raise money and you're getting close to being out of money, you might think that you want to save costs and not get an attorney. You might feel that you don't want to get an attorney involved until you have a sure thing because traditional law firms bill by the hour. So if you send a term sheet, it's going to rack up charges and it's not a sure thing, then you're worried about that.

There are other law firms out there though (like [Atrium](#)) that do everything on a flat fee basis when it comes to term sheet negotiation. So if you engage these firms for a capital raise, it's all included. You can send them as many term sheets as you want, because they'll look at them and help you weigh them.

So, when it comes to term sheets and keeping expenses, hiring an attorney is not somewhere that you want to cut corners.



6. Avoid These Investor Pet Peeves



The last thing you want to do is sour a deal with an investor because you made a silly mistake that gave them cold feet. Here are a few of the biggest mistakes startups make that can ruin a deal:

Failing to establish a clear line of dialogue. When undergoing the term sheet negotiation process, you want to make sure that you feel comfortable calling the investor, communicating with their counsel, and that everyone involved's roles are clear. Otherwise there can be cross communication and then that's where the confusion and hurt feelings can start. You need to make sure that you're either speaking to the right decision maker or that the person has the authority to act on behalf of the other party.

Not letting a fundraising be over. Fundraising is not a fun experience for either the investor or the founder. Often, however, a founder will prolong the pain of a fundraising by continually coming back to an investor with 10 or 15 things to negotiate that they've already addressed. A really experienced founder will typically realize that it's more important to be done than perfect - which can end up saving a lot of time and energy.

Lack of transparency. The business diligence process for an investor can take quite a bit of time and effort. You only make this process harder if the investor has to keep submitting request after request for more information. The best way to expedite this process is to set up a Dropbox folder (or the like) with a bunch of folders in them for your financials, your business plan, your marketing plan, etc. If you have all that it will make it so much easier for investors so they don't have to keep going back to you with data requests.

About the authors



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