

TERM SHEET JARGON BUSTER

UNDERSTANDING THE KEY TERMS
IN YOUR TECH STARTUP TERM SHEET

NIALL MCGINNITY

If you are not familiar with a term sheet your first view may be more than a little daunting

So by this stage I'm sure you know what a term sheet is. You've heard some of the more popular terms but do you understand what they mean and what their implications can be. In case you haven't heard of these contact us for a free glossary which outlines some of the most popular investment terms a startup is likely to come across.

All investments have an inherent level of risk – it's unavoidable and is why some of the terms of investment can be conditional and stringent. However, when you do find yourself negotiating a term sheet it is important that you can negotiate the terms within it. From experience, I think it is important that you understand the term sheet from both sides so you can make an effective argument from your perspective.

We all know the early stages are the most risky – the earlier, the riskier. These are the stages where you'll maybe have an Minimum Viable Product (MVP), some market validation, no sales, small team (possibly you, another founder and some outsourced developers) – you may even be earlier than this again! So for an investor investing at these stages they need to take steps to mitigate the high risk – not really that surprising and they wouldn't be doing a very good job if they didn't! But what are these mitigating factors? How do they attempt to protect themselves and justify the risk they are taking? There are several clauses in a term sheet that are there to do just that. They are not uncommon and will pop up time and time again.

This article discusses some of the most popular and more contentious aspects of a term sheet that you are likely to come across.

Reverse Vesting

One of the more popular clauses I've seen pop up is that of reverse vesting. Basically you have to relinquish all your shares on completion of investment and earn them back over a pre-defined vesting period (e.g. straight line over 3 years). I find this to be a rather contentious clause among the startup community. This protects the company and other shareholders from the outset – it will ensure you can't walk away with a large portion of shares within the early years of the investment. However, my argument would be that it should be reserved for the earliest of the early startups – those that have an idea but have put very little/no money into it and devoted



little time to developing the business out. Therefore they haven't really made the sacrifices or commitment to justify the large shareholding that they have and it really will be a result of the capital injection from the investor that will really bring the boost the company needs to get it progressing forward. However, if you are not in this category and you have built a company, developed a prototype, dedicated time and effort, made personal sacrifices including financial input then you will be in a better position to argue your right to keep your shares at the outset and not be subject to a vesting schedule!

Leaver Clauses

'Bad Leaver' situation typically arises if a founder is dismissed for cause e.g. gross misconduct. This can apply to a pre-defined period of time, or it can be infinite. In this instance, it is likely you will lose all or a pro-rata portion of your share entitlement and are paid a below market price for the remainder (possibly even nominal value). Seem unfair? If you are dismissed for gross misconduct is it fair that you walk away with all your shares and are paid market value? Think about it as if you had a co-founder, they misbehaved and were dismissed as a result – would you be happy that they walked away scot free? I think not ... Moral of the story – don't do the crime if you can't do the time. A 'Good/Early Leaver' arises if you leave due to illness or on agreeable terms – again, you will walk away with all or at least a pro-rata entitlement but in these situations you will be paid a fairer value (possibly as high as market value).

So this hasn't started off too well has it – you've been subjected to reverse vesting and had all your shares taken off you at the outset and if you leave within a pre-defined period of time it is likely you will only get some, or none of your shares back and possibly not at full value! You aren't overjoyed at this prospect and you certainly aren't reaching for the nearest pen to sign on the dotted line are you?

The bad leaver clause effectively protects the company and other shareholders. The investor won't want you to be able to walk away with a juicy sum of their money after three months. The good and early leaver clauses will protect you as the founder. The leaver clauses are pretty standard. Their inclusion is rarely subject to negotiation but the conditions under which they apply can be. So for example I have seen bad leaver clauses that are not bound by any time period and apply as long as the founder remains in the company or good leaver clauses that only offer half of market value for the shares. These are the aspects that can be subject to negotiation – so I would avoid requesting their removal altogether (because they won't be and you might look a little silly for asking), concentrate on getting the terms to an acceptable point.



Pre-emption

There will generally always be pre-emption rights. Basically, the investors have the right to first refusal to a pro-rata portion of a new share issue. These are paid for at the share price set for the round. This is an optional right and can be waived. These are pretty standard and not one of contention in my opinion – unless you had an investor you didn't like and wouldn't want them to be entitled to buy any more shares, even if they are paying for them. If that was the case I would ask yourself why you were accepting their money in the first place?!

It's almost a courtesy to offer existing investors the right to first refusal before offering them to other investors. Like your last rolo – would you offer it to the guy (or girl) that is sitting 10 tables away, or would you offer it to the person you are with? Maybe you'd just eat it yourself and if you can afford to do that then you don't need to worry about getting new investment ...

I have never had a situation when the pre-emption caused any disagreement, however I did find a large number of people didn't quite understand what they were or how to deal with them. So it is important that you understand the protocol in your particular agreement as to the agreed procedure for notification of pre-emption rights.

Anti-Dilution

The next item on my hit list would be the anti-dilution clauses. Most term sheets will probably have some form of an anti-dilution clause. So, to understand these we must first have an appreciation for what dilution means. I find that the definition of this term changes depending on who you speak to. There are those that believe in the broad definition – a shareholding is diluted on the issue of more shares (e.g. funding round, options etc). Then there are those that would argue dilution only really occurs if the shares being issued are at a lower share price than that of the previous round i.e. a value dilution. If the share price is the same, or higher then the shareholding itself will hold the same or greater value and therefore this is not dilution. Get clarity on what the investor means when they use the term dilution – is it shareholding dilution, or value dilution.

Anti-dilution clauses cover situations where on the issue of new shares, the investor will be granted their pro-rata entitlement at no additional cost – hence they maintain their shareholding, but don't have to pay for the extra shares! This is popular when the share price is set below that of the previous round, and hence there is a value dilution taking place. The justification for this tends to be that they took the original high risk, therefore they shouldn't be subject to dilution



at follow on rounds of lower valuation, they should be protected. The opposite can also be true, when the share price goes up, they are also issued pro-rata portion of shares at no additional cost. This is where the definition of dilution is important as this relates to the shareholding dilution, rather than value dilution. So, what is the justification for wanting this? Again it relates to that risk they took – now since the valuation has gone up they should be rewarded for the part they have played so far and they shouldn't be required to pay for it! Making sense?

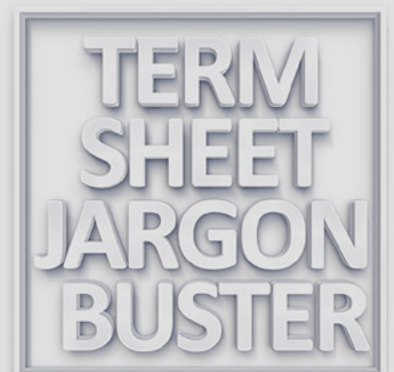
How do you negotiate your way around this? As I keep saying, in order to negotiate you must understand the principle behind it. So you understand they are taking a risk with you, the company and, of course, you appreciate that. However – should they protect themselves from being exposed to the possibility of a falling share price? Should they be rewarding themselves for a job well done when the share price increases? Ultimately you will be diluted (either way), so why shouldn't they? Anti-dilution clauses can be detrimental to a founders motivation – they put in the time and work but yet don't receive the same treatment on their shares, they can also be really off putting to future investors – why should a previous investor get something for nothing when they have to pay?

An investor may be adamant to keep these clauses in so I again I would suggest that you try to negotiate their terms. Ways to negotiate would include capping them at a certain value/number of shares, make them conditional so that the investor has to participate in the round in order to be issued shares under the anti-dilution clause, but probably one of the most important elements to protect against a falling share price is to make sure the company is not over valued in the first place!!

Liquidation Preference

Another favourite clause is Liquidation Preference. This is when the holders of a specific type of share (e.g. round 1 preferred shares) are to be paid before any other shares. So, they get their money back first, and the rest is divided up accordingly. Get the investor to clarify what type of liquidation preference they are seeking. There are some that are less favourable to the company that will see the investor receive original investment, plus proceeds, plus proceeds from converting to ordinary shares as well – effectively a “double-dip” at the pot!

With this preference there can also be a Liquidation Multiple attached – they don't just want their investment back, they want at least X times their investment back, then whatever is left is divided out accordingly. These tend to be associated with preference shares (or preferred



shares). The reasoning being that they were first in, they took the greater risk and therefore should receive money back before anyone else, and at a pre-defined premium.

When discussing liquidation multiples it would be advisable to understand what the impact will be further down the line – remember these clauses will be carried forward to future rounds and therefore you will need to have some understanding on the impact it will have on you and future shareholders.

One method to try to negotiate a better position on this would be the introduction of a cap – therefore, there is a ceiling in place as to how much they can receive.

Valuation

An investor will more than likely always have a lower valuation in mind than you. They want as much bang for their buck. Who can blame them! However, what they usually do is work backwards – they are investing £X in your company, they want X% of the equity and therefore valuation = £Y. So be careful if you are talking pre or post-money valuation. Negotiate the valuation by analysing the term sheet in its entirety. Do they want 30% of your company, reverse vesting, infinite bad leaver, full anti-dilution, preference shares including liquidation multiple? Assess each item individually then collectively as a full offer and begin to negotiate.

I find a lot of founders go straight for the valuation – “What?? You want how much??” then they take a strop and walk away. I have seen founders congratulate themselves at winning on the valuation argument with an investor – but while being their own captain of the universe they have given up so many of their other rights because their only focus has been valuation – they have managed to retain 80% of their company but will ultimately get diluted to beyond recognition by the next funding round and probably be dismissed at the same time.

Nuvem9 specialise in working with startup and early stage businesses and have vast experience in the investment process. Contact us today via the contact form below to set-up a free consultation on how we can assist your business.

