

Founder Focus: FAQs for Start-Up Success

UK Term Sheets: The Basics

Summary

Getting a term sheet from an investor is an exciting moment for any founder and it's important to consider the terms offered carefully. A term sheet is a document that outlines the main terms and conditions of an equity investment – key terms include:

1.  **Funding structure and terms**
2.  **Valuation and dilution**
3.  **Investor rights**
4.  **Exits**
5.  **Leavers**
6.  **Option pools**

Although generally not legally binding (with the exception of any exclusivity or confidentiality provisions and sometimes break fees in the event the investment doesn't complete), they evidence the serious intent of the parties and lay the groundwork for the negotiation and drafting of the long form legally binding documents.

Agreeing the key terms in advance in a term sheet helps to reduce the level of negotiation required when drafting and reduces the potential for disputes between parties further down the line.

Key terms to look out for include:

1. **Funding structure and terms** – This is the type and amount of funding that the investors will provide. Rather than provide their full investment on completion, some investors may invest in tranches subject to any conditions and milestones that the company must meet being satisfied. The type of funding can vary from equity (e.g. preferred shares, preferred ordinary shares or ordinary shares), debt (e.g. loan notes or convertible loan notes) or other equity instruments (e.g. advance subscription agreements or SAFEs).
2. **Valuation and dilution** – This is the amount of money that the investors are willing to pay for a certain percentage of the company's equity. It determines how much the founders and existing shareholders will own after the investment, and how much their ownership will be diluted. You should be clear when negotiating as to the difference between your "diluted" and "undiluted" share capital, with the former being the final share capital position after all possible forms of convertible investments have been exercised. Your company's valuation will typically be based on agreed multiples of various metrics (i.e. revenue, customers, etc.).
3. **Investor rights** – These are the rights that the investors will have in relation to the company, such as consent rights, board representation, information rights, anti-dilution rights, warranties and liquidation preferences. These rights and protections are designed to give the investors control and influence over the company's decisions and operations, and to protect their investment from being diluted or devalued by future events or actions.
4. **Exits** – This is the plan and timeline for the investors to realise their return on investment, by selling their shares to a third party or through an initial public offering. The term sheet may include clauses that give the investors the right to initiate or participate in an exit, or to veto or approve an exit proposed by the founders or other shareholders (exit rights or consent rights). Any drag along rights and/or tag along rights should also be considered at this stage.

5. Leavers – Leaver provisions are clauses in investment documents that determine what happens to the shares or options of a founder or key employee who leaves the company. Leaver provisions typically classify leavers as good, intermediate, or bad leavers (and sometimes very bad leavers) depending on the reason and timing of their departure. They are often heavily negotiated because of the balance to be struck between the exiting founder or key employee retaining equity as reward for the value they've created up to the date of their exit versus getting shares back from an exiting founder or key employee to incentivise their successors.

6. Option pools – An option pool is a portion of the company's share capital that is reserved to incentivise current employees and/or other stakeholders and to help attract new talent. The option pool is typically created or increased before the valuation of the company is determined, which means that the existing shareholders (i.e. founders and previous investors) bear the dilution of their ownership.

Final thoughts

Entering into a term sheet is an important decision for any business and its founder and here's some final food for thought:

 Do	 Caution against
'Date' investors	Early term sheets / lengthy exclusivity periods
Get references from other portfolio companies	Investor approval processes (Investment Committees etc.)
Seek multiple term sheets	Aggressive liquidation preference
Engage lawyers in the term sheet process	Reserved matters incompatible / over-the-top for your company
Obtain accounting and tax advice on the proposed structure	Unrealistic pre-money valuation

Any questions?
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