Top ten tips for financing term sheets

Corporate Update

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When it comes to angel and venture capital financing, the principal document between the issuer and investor(s) is the term sheet. As with letters of intent for buying or selling a business, a good term sheet will outline the key terms and conditions of a transaction so the parties can be on the same page before spending the time and money finalizing final legal documents. Here are some key tips for financing term sheets:

1. Don’t give away the farm

Angels and venture capitalists are sometimes reluctant to sign confidentiality agreements because they are in constant contact with multiple entrepreneurs, which leaves them vulnerable to claims that they transmitted confidential information between parties. This requires a balancing act by entrepreneurs, who must demonstrate why a product or company is unique without giving away their secrets.

2. Binding or not?

The essence of a term sheet is that it is a set of terms that the parties anticipate agreeing to or hope to achieve. It is, by definition, written before a formal contract has been executed. As such, term sheets are not generally binding and any terms that you want to be binding should be explicitly set out.

3. Terms to include

Certain sections are common and recommended for a financing term sheet. Some of these sections will be binding even if the term sheet itself is not – these include:

- *Expenses* - who is responsible for paying what?
- *Confidentiality* - the company will be providing a lot of sensitive information and the investor may have competitor companies as part of their investment portfolio.
- *Exclusivity* - is the company entitled to search for other investors while negotiating this financing? Like with a purchase and sale transaction, you don't want your hands tied for longer than is necessary, and especially if negotiations with the investor start to go sour. It is advisable to limit the timeframe as much as possible (30 to 90 days is typical) from execution of the term sheet, providing incentive to the investor to close the deal in a timely manner.

Other sections that are not usually binding if the term sheet is non-binding, but are important nonetheless, include the use of proceeds (what will the investors' funds be used for) and securities law requirements (if the company is not a reporting issuer, the investor must fit within one of the private placement exemptions).

4. Build a functional capitalization ("cap") table

You will want to include the issued and outstanding securities (including any options or convertible securities) and the anticipated numbers following completion of this round of financing. It will be beneficial to everyone if these numbers are prepared in a table or spreadsheet that allows the investor to see each party's basic shareholdings and fully diluted shareholdings, and allows certain inputs to be adjusted. As the valuation of the company or pricing of the offering gets negotiated, or simply to run "what if" scenarios, a well-produced cap table can be a powerful tool.

5. Pick the right kind of security

The most important aspect of a financing term sheet will be what the investor gets for its money. Is the investment for debt or equity, or a hybrid of the two? What will the security look like - simple common shares, whereby all shareholders share equally in the growth and liquidation of the company? Preference shares, with or without warrants or cumulative dividends? A debenture that is convertible upon some triggering event such a sale of the company? What you end up offering will largely depend on the market and the type of investor you're looking for (for example, individual vs. institutional).

6. Raise enough money

Fundraising is extremely time-consuming and you almost always need more money than you think you do. There are certain sunk costs associated with raising money, such as professional fees, subject to the next point, it's always better to spread these costs over more invested dollars. Most importantly, once this round of financing is complete, ensure that you have enough funds to get you to a new (higher) valuation for the next round.

7. Take care in your valuation

Raising as much money (or more) than is necessary will need to be balanced against how much of the company you are prepared to give away. You will need to determine what percentage of the company the investor will get for what he, she or it is investing; this will require a determination of the fair market value of the company. This aspect of the term sheet is a negotiation and an iterative process, so be careful not to lead with your best offer and price. Do your homework on what is comparable and what is market, and always have a financial advisor assist with the valuation exercise. (Keep in mind that the fully diluted number of shares should usually take into account an additional "float" for employee options (a common way to incentivize key employees, which is essential to increasing value in the long run).) If founders give up too much too early, they risk losing their drive to create value for all shareholders.

8. Investor rights

In addition to the type of security, investors will be looking for what rights will be attached to the securities offered. These rights may include a board seat, consent rights (over certain material decisions), pre-emptive rights on future share issuances, tag-along and drag along rights, and a long list of additional less-common requests.

9. What's market?

Similar to the US with its suite of documents courtesy of the NVCA, Canada has a suite of financing documents provided by the CVCA. These documents include a term sheet, subscription agreement and shareholder agreements.

10. Always have a plan B

As with most negotiations, how successful one is in achieving a good result depends on the leverage one has and the options created. It is critical to have a backup plan in case an investor is "off market" or attempts to get too friendly a deal. Having the power to walk or back away from the table is key; not having the power to do so is potentially crippling.

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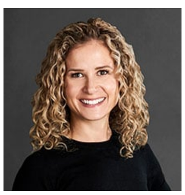

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