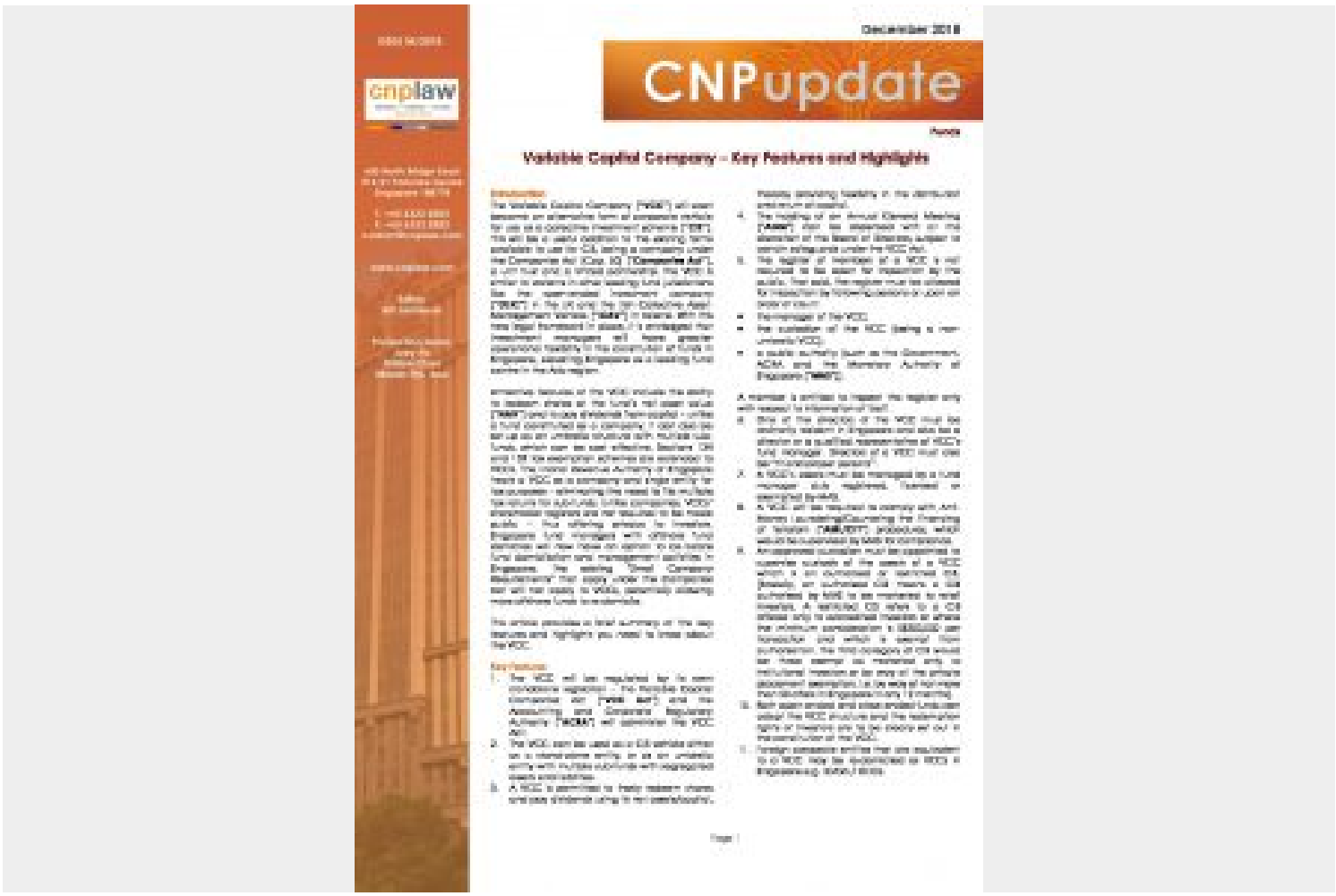
CNPLAW BUSINESS GUIDE SERIES: UNDERSTANDING THE TERM SHEET

Posted on November 16, 2022



Category: CNPupdates

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Published: 16 November 2022

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INTRODUCTION

The term sheet, or sometimes referred to as the letter of intent or memorandum of understanding, is a preliminary document containing a summary of key terms agreed between parties to be used as a basis for preparing definitive agreements. In the context of equity financing, the unassuming yet impactful term sheet can either make or break negotiations in a funding round. In this article, we shed some light on the term sheet for Singapore start-ups looking to secure equity financing from external investors.

The big picture

Here is how the term sheet fits into the big picture and why it matters. While the term sheet is usually drawn up at the start of talks with investors and is intended to be only preliminary to kickstart the funding process, it records the parties' starting positions on key terms which sets the tone for negotiations on the definitive agreements. This is the case even if the term sheet is not legally binding as it is meant to signify the parties' good faith in seeing the transaction through, much like a gentlemen's agreement. In the course of the funding process, the term sheet will often be cited as a reference point and a sharp deviation from its terms may risk rocking the boat. As such, the term sheet should not be taken lightly, especially if it is legally binding as it may end up being the only contract that parties can rely on if they fail to reach a consensus on the definitive agreements.

The use of the term sheet does not usually come into the picture until the company is ready to raise significant funds from external investors, where each funding round is typically demarked as series A, B, C and so forth. This is because venture capitalists and other sophisticated investors coming in at such rounds with higher stakes often demand a greater level of assurance upfront through the term sheet compared to earlier investors at pre-series funding rounds. It is common for the lead investor in a series funding round to dictate the form of the term sheet based on the lead investor's preferred template or the previous term sheet used by the company in its last funding round (which goes to show the lasting effect of a term sheet in setting precedent for future funding rounds).
The life of the term sheet is intended to be a short one, surviving until such time the definitive agreements are executed to supersede and replace the term sheet. The main definitive agreements based off the term sheet for a series funding round will usually be the share subscription agreement and the shareholders' agreement from which other transaction documents may follow.

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Binding or non-binding?

The term sheet can be legally binding or non-binding on the parties, being the company and the incoming investors. While a legally binding term sheet may seem attractive to the company to secure the investors' financial commitment as early as possible, the company should be wary of agreeing too soon to terms which it has yet to discuss with its key shareholders, especially if such terms adversely affect their rights. The company ultimately needs to perform a balancing act to negotiate the terms with the investors whilst ensuring that such shareholders will be on board with such terms. If a longer runway is required for this, a non-binding term sheet may be more appropriate to give the company the flexibility it needs to adjust the terms down the line.

It should be noted that a non-binding term sheet can still contain certain binding terms, such as confidentiality provisions to keep the details of the proposed investment confidential (including any information disclosed for the purposes of the investors' due diligence on the company), and exclusivity provisions often requested by investors to restrict the company from concurrently entertaining third-party offers for a limited period of time.

The key terms

The key terms in the term sheet typically revolve around three areas:

1. the deal economics (e.g. the investment amount, the class and number of shares to be issued and the ownership percentage they represent, and the valuation of the company used to calculate the share price);
2. the rights attached to the class of shares to be issued (e.g. any dividend preference, liquidation preference, conversion right, redemption right, or anti-dilution protection); and
3. specific investor rights and requirements (e.g. any board seat, inclusion in quorum for meetings, reserved matters, information rights, pre-emption rights, right of first refusal, right of first offer, tag-along right, drag-along right, founder liability, or founder restrictions).

Below are general tips on how start-ups and their founders can navigate some of the more contentious key terms. This is provided for information purposes only and does not constitute legal advice which should be sought on a case-by-case basis.

Valuation	Ensure parties are negotiating with the same valuation metrics in mind (whether pre-money, post-money, or on a fully diluted basis) and look out for provisions which allow investors to adjust the share price in their favour or otherwise be compensated for any changes to the pre-agreed valuation of the company.

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Dividend preference	Investors may ask for an annual dividend rate, being a percentage of the share price, on a cumulative / non-cumulative basis and a compounding / non-compounding basis in priority to any earlier class of shares. Consider negotiating for a non-cumulative basis (whereby dividends are declared and paid for any profitable year and do not accrue for non-profitable years) and a non-compounding basis (whereby the dividend rate will only apply to the share price and not together with any accrued dividends) in favour of the company.
Liquidation preference	The liquidation preference determines how the investors will cash out of the company upon the occurrence of a liquidity event, which the investors may try to define as broadly as possible to include not only the winding up of the company but also a trade sale or even a change in control of the company. The liquidation preference is usually set to a multiplier (e.g. 1x or 2x) of each investor's initial investment amount in priority to any earlier class of shares, and can be participating (giving the investor upside benefits via a double dip to receive the multiplier amount and participate in remaining proceeds of the liquidity event in proportion to its ownership percentage on an as-converted basis) or non-participating (giving the investor downside protection via a single dip to receive either the multiplier amount or convert its preference shares to ordinary shares to receive its pro-rata share in the total proceeds of the liquidity event). As the liquidation preference can set a precedent for future series funding rounds and eventually affect the exit strategy of the founders who are usually at the bottom of the liquidation waterfall, consider keeping the liquidation preference minimal at a 1x multiplier on a non-participating basis.

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Anti-dilution protection	Where the company issues preference shares to investors with a right to convert such preference shares to ordinary shares (whether at the investors' option or upon the occurrence of certain events such as an initial public offering of the company), the investors may ask for anti-dilution protection so as to be compensated in a down-round where the company subsequently issues new shares at a price lower than the conversion price offered to the investors. This is achieved by adjusting such conversion price downward based on any of the following formulae (ranked from least to most company-friendly): (i) full ratchet (where such conversion price is adjusted to the lower price in the down-round); (ii) narrow-based weighted average (where such conversion price is adjusted by considering only outstanding ordinary shares in issue and/or issuable upon conversion of the investors' preference shares); or (iii) broad-based weighted average (where such conversion price is adjusted by considering all outstanding ordinary shares calculated on a fully diluted basis). The broad-based weighted average formula is most commonly used by companies as it results in fewer ordinary shares being issued to the investors upon conversion of their preference shares, and consequently less dilution of ownership percentage of the founders and other shareholders with no anti-dilution protection. Consider introducing exceptions to the anti-dilution protection, such as share issuances pursuant to the company's employee share option scheme or the exercise of any options, warrants or convertible securities.

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Reserved matters	Investors receiving only a minority stake in the company will often request reserved matters to allow them to veto and hence control certain matters relating to the company (whether at the board or shareholder level) despite having no general voting power over such matters as a minority shareholder. Ensure the reserved matters are not likely to impede the founders' ability to operate the company's business. In particular, consider setting less rigid reserved matter consent thresholds by tying them to shareholding percentages rather than particular investors, and qualifying any reserved matters to exclude low-risk recurring activities of the company. If the founders lose board or shareholding control over time (which is inevitable the more investors the company onboards), reserved matters can similarly be used by the founders to retain some control over the company by adjusting the reserved matter consent thresholds in their favour.
Drag-along right	A drag-along right benefits specified majority shareholders looking to sell their shares to a third-party buyer by compelling the remaining shareholders to participate in such sale on the same terms, thus increasing the marketability of the company's business for a trade sale. Consider aligning the triggering conditions for the drag-along right with the founders' exit strategy to allow the founders to cash out on such conditions, e.g. by prescribing a minimum sale price or determining whether the drag-along sale should cover all and not only some shares or extend to an asset sale.

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