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Coming to Terms: Document Spells Out Investor/Owner Relationships

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An entrepreneur who's ready to let investors contribute equity to her promising venture needs to shape an agreement that allows others to share in the rewards but lets her retain significant control over her creation.

The rough draft of that agreement is called a term sheet. It's essentially the template for the legal contract that ultimately spells out the responsibilities and relationships of business partners.

Commonly used by professionals during pre-investment negotiations, a term sheet can also be used by small-business owners to discuss terms with investors, including friends and family members. The document aims to protect the interests of all parties to the deal and prevent the disputes that can destroy personal and professional relationships if things don't work out as expected.

The term sheet is for discussion only; neither party is bound by it until investors have researched the business's financial records and both sides have signed a stock-purchase agreement. Each side, of course, will press for the most palatable terms.

Small Print, Big Deal

The typical term sheet begins by describing the proposed transaction. It outlines the amount of funding the investor proposes to offer, how much ownership he receives in exchange and what the equity will be used for.

Investors and owners often clash over the statement of a company's pre-investment value. If the parties can't agree on a number, an external appraisal might be required, as owners frequently think their business is more valuable than investors do. An entrepreneur might attract multiple term sheets from different investors, but most investors have the sophistication to arrive at pre-investment values that are not significantly different from each other.

The term sheet notes an ideal closing date for the transaction and sets conditions for the investment — such as investor satisfaction with the findings of due diligence and approval of the company's board of directors. Most term sheets insist that the company maintain its financial health until the deal is sealed at closing.

Investors scrutinize the voting and participation rights the owner is willing to offer, as most expect a say in major business decisions, such as a merger, reorganization, sale, dividend declaration, debt assumption, board of director changes and issuance of other securities — such as stocks — that would dilute their ownership.

Investors often want a seat on the business's board and unbridled access to the business and its financial projections, plans and statements. Some demand to install their own management, though this might be a hard sell for the founder and primary owner.

Down the Road

Owners and investors often enter negotiations with different ideas about how the partnership will evolve and when it will end with a sale or other type of return on investment. An investor often wants to get in and out of a startup as quickly as possible and might want to exit before the owner believes that the potential for the company is fully realized.

Term sheet negotiations are all about aligning interests for mutual benefit, so both sides should aim for a compromise document everyone can live with — one that accommodates the desires of owners and investors and is balanced and fair. The object, after all, is to give an embryonic enterprise the funding and leadership it needs to provide a product or service and — in doing so — enrich its creator and financial backers.

For more information, visit Arrowhead Center at New Mexico State University at www.arrowheadcenter.nmsu.edu.

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