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Written Terms: The First Step Toward Avoiding Disputes

By Finance New Mexico

A legal contract that spells out the responsibilities and relationships of partners in a business venture protects the interests of all parties involved, and it can guard against the messy disputes that can potentially sever friendships and family ties when an entrepreneur relies on friends and relatives to be his initial investors or workers and things don't turn out as expected.

A term sheet can serve as a template and preliminary document for such a contract. Commonly used by professional investors when negotiating their involvement in a business venture, a term sheet can also be used by small-business owners to start discussions of investment and responsibility terms with family members. The term sheet is for discussion only; neither party is bound by it until both have signed a stock-purchase agreement or other stock-ownership document.

When the investment is financial and the investors are professionals, the term sheet leads to due diligence, the process of research into the market and the business's financials.

Investments by Professionals

The term sheet begins with a description of the proposed financial transaction. It outlines the amount of funding being offered and how much ownership the investor receives in exchange, which is usually an equal amount of common or preferred stock. The sheet includes a statement of the company's value before the investment — something that is often controversial, as owners frequently think their business is more valuable than investors do.

The term sheet notes when the transaction is likely to close — usually within a specific number of days after both parties accept the document. Included is a general description of what the investment will be used for. The term sheet usually sets some conditions, such as completion of due diligence to the investor's satisfaction, mutually satisfactory legal documentation and board of director approvals. Most term sheets insist that the company's business prospects suffer no significant setbacks between the dates of the term sheet and the closing.

Voting and participation rights are delineated on the term sheet, and investors will expect that major business decisions be subject to their consent. Typical decisions requiring investor approval include mergers, reorganization, sale, dividend declarations, assumption of additional debt, board of director changes and issuance of other securities — such as stock offerings — that would dilute an investor's ownership position.

Investors usually want a seat on the business's board, the right to inspect or visit the business whenever they want and access to financial projections, plans and statements. Sometimes they insist on putting their own management in the company.

When negotiations reach this stage, a business's owners can no longer open discussions with other investors or talk to anyone except legal counsel about the negotiations they've had with the potential investors or the terms they're contemplating.

Family Sweat-Equity

Entrepreneurs who promise family members a part of the business in exchange for work or the use of property should use the term sheet model to reach agreements that clearly define responsibilities, liabilities and stock ownership. Business owners who convert term sheets into legal documents are more likely to keep family relationships intact when revenues take off — or decline — and the business looks much different from what it did at its founding.

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