Last Updated: **6 Dec 2023**

EWOR

The Ultimate **Term Sheet Cheat Sheet**

While fundraising, you will encounter a whole host of legal terms and provisions.

Understanding these terms and their consequences for your start-up is crucial for the future success of your start-up.

But how can you find out if an investor is making outrageous demands or whether their demands are market standard?

In this Ultimate Fundraising Cheat Sheet we have compiled a list of terms used in convertible note agreements and terms sheets, added an explanation and the market standard for each term or provision!

A few notes before you read on:

Please note that this document should in no way be considered or interpreted as legal advice.

We strongly recommend engaging a lawyer who understands the ins and outs of investor-backed start-ups to ensure all contracts and agreements are compliant with the laws in your jurisdiction.
In addition, your lawyer can save you a lot of time, will be more proficient at navigating the legal intricacies and can offer guidance on what conforms to industry norms and what doesn't.

Also, keep in mind that fundraising can come with significant costs.
The exact costs vary significantly depending on the jurisdiction you're in.

For Germany you can expect the following for a priced seed round:

- €10-20k for the company's lawyers plus €10-20k for the lead investor's lawyers plus €10-20k notary costs.
- For a CLA/SAFE-based seed round, it will be significantly less.

We would love to hear your feedback on this Cheat Sheet!
If you have a second to spare, let us know what you think **here**

Legend

Always negotiated | Sometimes negotiated | No need to negotiate if market standard

Agreements

Term Sheet
A 'term sheet' is a non-binding document outlining the key terms of an equity investment deal between an investor and a target company.
While most of its contents are not legally binding, it can have significant reputational consequences if either party backs out after signing.
Some sections, like exclusivity and confidentiality provisions, are legally binding. Lawyers often use the term sheet as a template for drafting more detailed investment agreements, ensuring clarity and avoiding misunderstandings in subsequent negotiations.
Typically, a lead investor (i.e. not the start-up) provides the term sheet.
Term sheets often include deadlines to maintain a sense of urgency, but these deadlines are typically not strictly enforced. Founders should not feel pressured by such deadlines.
Choosing investors for the cap table is a crucial decision, and founders should be empowered to make informed choices.

Convertible Loan Agreement (CLA)
A loan agreement between an investor and a company whereby the investor makes money available to the company now that is either paid back or converted into equity when a predetermined event (such as a future funding round) occurs.
A convertible loan is an instrument often used by angel investors and does not have to be preceded by a term sheet.

Advance Subscription Agreement (ASA)
An equity instrument where investors invest money now but receive shares when these are issued at a future funding round.
Similar to CLAs, the money is invested into the company before the investor receives shares.
However, the difference between a CLA and an ASA is that an ASA will always result in the issuance of shares, while under a CLA the invested amount can be repaid in cash. The Advance Subscription Agreement is designed to comply with UK law.

Simple Agreement for Future Equity (SAFE)
An equity instrument with a lot of resemblance to ASAs.
SAFEs are designed to be legally compliant with US law, whereas ASAs are designed to comply with UK law..

Valuation Terms

Pre-Money Valuation
Your pre-money valuation is your valuation before receiving the money.

Post-Money Valuation
Your post-money valuation is your pre-money valuation increased by the investment sum raised. If you raise €1M on a €5M pre-money valuation, your post-money valuation is €6M.
Your dilution is calculated by dividing the investment sum raised by the post-money valuation.
In the example, your dilution would be ~17% (€1M invested divided by the €6M Post-Money Valuation). A dilution of 10 to 20% as a result of raising a pre-seed is common.

Vesting Terms

Vesting Terms
How the founder's shares vest over time.
Say, the founder gets 25% of shares after 1 year (cliff) and then the rest of the 75% shares monthly over a period of 3 years.
A vesting schedule with a one-year cliff and a vesting period between 3-5 years is reasonable for founders.

Good Leaver / Bad Leaver
A good leaver is allowed to keep the vested shares.
A bad leaver has to sell their vested shares to the company or the investor at nominal value. These terms can be defined differently.

Acceleration
In some term sheets, it is negotiated that all founder shares vest immediately at the exit event of the company.

Convertible Loan Agreement (CLA) Terms

Maximum lenders
Specifying how many lenders are allowed in total.

Conversion Event
Defines what constitutes a conversion: usually an equity financing round

Qualified Round
The minimum amount of equity financing that needs to be raised to trigger the conversion event.

Maturity Date
The loan converts to equity in the absence of a Conversion Event.
A date 18-24 months in the future is ideal as that gives you time to raise your next round.
A period of 12-18 months would be acceptable.

Upper and lower Cap
The lower cap valuation is usually used when converting the loan into equity at the maturity date.
The upper cap is used in case an equity financing round is raised at a valuation that is higher than the upper cap and effectively results in a discount for the convertible loan investor.
Although an upper cal is quite common, some oversubscribed start-ups manage to raise uncapped loans.

Discount
The percentage discount at which the convertible loan will convert relative to the next qualified priced round. A typical discount is between 10-20% of your next valuation.
For example, if you raise your next round on €10 per share, your convertible loan investor will be converted at €8 per share if you have agreed on a 20% discount.

Interest
Since a convertible loan is a loan, you will be required to specify an interest rate in most jurisdictions. It is quite typical to agree on the minimum interest rate as defined by law.
An interest between 2-7% is typical. The interest accumulates over a certain period and is added to the outstanding loan amount.

Subordination
We highly recommend you include a subordination clause in the loan agreement to protect yourself. A subordination clause prioritizes other debt over the repayment of the convertible note and makes it easier for you to secure additional financing.

Financing Terms

Investment amount
Typically, you specify an initial investment amount in the CLA / SAFE / ASA or Investment Agreement.

Tranches
The investors can request to pay their money in tranches (e.g. upon signing, in 6 months, and in 12 months). Tranches can be time-based or milestone-based. We recommend to try and avoid tranches as much as possible.

Milestone payments
Specifies specific milestones under which the second investment amount is due in a tranch. Tranches tied to milestones should be avoided in the early stages of a company – it might set disadvantageous incentives for founders who need to operate with maximum flexibility.

Investor Rights

Advisory Board
Sometimes, investors request the company to have an advisory board. Whoever sits on it should not only represent the interests of the shareholders but also bring experience and expertise to the company and offer support in difficult times. An advisory board usually consists of 4 to 6 members. It's not explicitly regulated by law, therefore, the tasks can be designed in an extremely flexible manner.

Future Rights
Often, future rights include information rights, lending rights, and the right to not dissolve the company without the consent of the lenders and/or shareholders.

Subscription rights
Usually, investors reserve the right to buy additional shares in future rounds to maintain their ownership percentage. This is called a **pro-rata subscription**.
Sometimes, there is a **super pro-rata subscription**, which means the pro rata amount can be invested X times. We do not recommend super pro rata, but pro-rata rights are common practice.

Information rights
Usually, investors want to see information such as your reporting OKRs, certain financial information, and so on. Monthly updates, quarterly financials, annual budgets & audits are market standards – excessive reporting requirements are a red flag.
The details and negotiation on information rights are often left to the long-form legal documents so don't worry if the term sheet is fairly short-hand on this topic.

Dividends
It is often defined that preferred shares are entitled to participate in the company's dividends on a 'pari passu' basis (i.e. profit that is distributed to the shareholders; note that it is a decision made by the management team as to whether to pay the shareholders or keep the profits in the company). Especially at an early stage, avoid paying dividends as that cash is often better spent growing the company.

Liquidation preference
This section governs the preference of the distribution of cash out during an exit. A 1X liquidation preference means that if you have an exit, your investors will first get their invested amount, and then you get your pro-rata amount.
A 5X liquidation preference gives investors 5X their invested amount back before the founders receive any cash.

- "Participating" implies that investors get the investment amount back in addition to a pro-rata participation of the exit proceeds.
- "Non-participating" implies that it's either the investment amount back or a pro-rata participation of the exit proceeds.

Anything other than "1x non-participating" for an early-stage start-up is a red flag.

Anti-dilution protection
This ensures that the investor can participate in future investment rounds with the same conditions they have benefited from in the past, to at least maintain their ownership percentage in your company.
There is a broad-based weighted average anti-dilution (most founder-friendly), weighted average anti-dilution, and full-ratchet anti-dilution (least founder-friendly). Anti-dilution protections can become very complex, especially when they come into action. It is recommended to include sample calculations in the final documentation to avoid misunderstandings.

Right of first refusal (ROFR)
This section forces anyone allowed to sell shares to first offer them to the other shareholders (sometimes only the preferred shareholders). It is market standard to have it implemented on a pro-rata basis, before being able to sell them to another potential buyer. It is recommended to negotiate a provision that requires those exercising the rights of first refusal to (jointly) purchase all of the shares to prevent them from disrupting the deal. ROFR is triggered when another buyer makes an offer.

Right of first offer (ROFO)
This is similar to ROFR but is even more friendly to the existing shareholders. In case a shareholder wants to sell shares and there is a ROFO clause in effect, they must offer their shares to the existing shareholders for purchase before they offer them to anyone external.

IP Protection
This is a section that grants investors the right to access a company's IP protection to guarantee that all IP is held by the company, and not employees and consultants involved in the R&D.

Closing conditions
This encompasses all the tasks that must be fulfilled before the deal agreement is closed (i.e. basis for the Due Diligence). Agree on a clear timeline and tasks for both sides leading to the round's closing. Ensure that conditions are within your control and are more mechanical than commercial. If commercial milestones are included, your investment will be delayed until the investor approves them. The term sheet may not detail all conditions; legal documents will cover them in more depth.

Limitations By Investors

Use of proceeds
A clause specifying that you can only invest and spend the money in line with your business purpose.

Option Pool
Forcing you to establish a pool of virtual or real options used for equity(-like) incentivization – mainly for employees, sometimes also for advisors. Usually, this is between 10-20% and within the interest of both the founders and the investors.

Redemption
A typical redemption rights provision provides that a certain percentage of the preferred stockholders can vote after a certain length of time has passed (five years is common), to cause the company to redeem all shares of the preferred stock for its original purchase price and possibly accrued and unpaid dividend. Redemption rights can be optional (based on certain conditions), mandatory (preferable for investors), and excluded (preferable for the founders).

Secondaries
Secondary investment occurs when the buyer does not purchase new capital from the company (capital increase as in usual funding rounds) but buys existing shares from investors or founders. There are three kinds of secondaries: Founders selling shares, investors selling shares, and ESOP holders selling shares.

Transfer restrictions
Usually, the investors make sure that the transfer of any shares must be approved by the board.

Founders lock up
The founders may not be able to transfer any shares for a set period without the investors' consent - usually, the lock-in period matches the vesting period. A lock-in is not always included, but if it is, it usually mirrors the vesting period.

Founders' pooling
Investors can force the founders to pool their aggregated voting rights into the decision of one single founder to be specified in the term sheet. Our recommendation: Don't sign this.

Drag along
This is a provision to make sure that if there is an acquisition of the company, single founders or minority shareholders cannot block it. If you are aiming for an exit, you should have a drag-along clause. Ideally, there is 75% ownership required which at the seed stage should still require both founders' votes to pass. It would not be acceptable that a lead investor alone can enforce it.

Tag along
This is a provision to make sure that if a certain amount of shares are transferred, the other shareholders can 'tag along' on a pro-rata basis.
For example, if an investor has a proportional co-sale right tied to a founder's sales, if that founder sells 10% of their shares the investor can require the founder to make sure the investor can also sell 10% of their shares.

Non-compete
This clause forces founders and specific shareholders to not engage in any activities that compete with the company's purpose and key business activities.

No-shop
This is a clause preventing founders from going 'shopping' - a term that VCs have invented to describe founders with signed term sheets approaching other VCs to get additional offers. The market standard is 4 weeks from the date of signing.

Last Updated: **6 Dec 2023**