Negotiating a Term Sheet

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In last month's column, I outlined some basic considerations for vetting a potential business opportunity. In working with physicians who are frequently approached to invest in new or growing businesses, I have found it helpful to develop some screening criteria. In this column, I will assume that the opportunity has passed the preliminary screening, and now it comes down to negotiating the deal. Obviously, I would encourage any reader to work with their advisors to analyze and negotiate an actual transaction. However, if you are going to diversify your investments by being an "angel investor" in businesses, then I believe it is also important to be educated on the fundamentals of deal-making. I also note that one of the things that can make this phase uncomfortable is that it is often a friend or family member asking you to invest in a project. This can make the deal negotiating awkward as you have to bargain for your investment terms. Therefore, I find that many investors like to use an intermediary in this context in order to provide a "buffer" and to avoid hurting any pre-existing relationships.

Deal or No Deal?

Some people seeking investors offer you a fixed "deal." These deals will often be summarized in the form of a private placement memorandum (PPM) provided to prospective investors. The PPM should describe the product/service in detail as well as provide information about the market opportunity and competition. The PPM should also contain information about the management team and financial information. Finally, the "offering" should be described which will usually be an equity offering, a debt offering, or a combination. The PPM should also include the governing corporate documentation (e.g. operating agreement or shareholder agreement). The company seeking investment will also usually ask that you sign a subscription agreement to codify the transaction. These should be carefully reviewed as they normally contain important legal terms. While anything is negotiable, a deal that is proposed to you as a PPM is typically not negotiable. The company seeking investment will try and standardize the offering and will usually shop it to numerous potential investors. That being said, if there are terms that are not acceptable then it does not hurt to try and negotiate the terms, particularly if you are willing to be the largest investor in the offering. In these type deals, you are usually a passive investor with little or no say over the day to day operations of the business.

Other times, someone may approach you and pitch an idea or opportunity with no set terms. This leaves you with a wide variety of alternatives to help fund the deal. In these deals, there is usually someone contributing "sweat equity" while the investors are providing the "cash." In these circumstances the modified golden rule usually applies – "He or she who has the gold, makes the rules." Before this power corrupts, I will say that the goal should always be win-win. This means that the investor gets a fair return for the risk involved, and the company is not overburdened with onerous terms. You want the sweat equity partner to be motivated, but not so much that he or she gives up. I also like to see that all of the partners have some "skin in the game." It makes me nervous when the sweat equity partner can just walk away from a deal and only lose some time. In these type deals, you are probably still a passive investor, but your management control over the business will probably be higher.

In order to facilitate this win-win situation, a term sheet should be developed to summarize the key deal terms. Sometimes this document is called a memorandum of understanding (MOU) or a letter of intent (LOI). Regardless of the document title, the goal is the same. Before you draft the legal documentation, you want to make sure that you are in sync on the business terms. Below I have begun summarizing some of the key considerations in developing a term sheet for a potential investment.

Debt or Equity?

The first order of business is to determine what the financial needs of the business are, how much will you invest, and will the investment be debt or equity? Some considerations for this include: Will you loan money to the company and therefore be a creditor? If so, under what loan terms? What will be the interest rate, payment terms, and security for the loan? Or, would you prefer to be an equity member actually owning an interest in the company? If you are an equity owner, then the question is whether you are a “preferred” owner with special rights that are superior to the “common” equity owners. These preferred rights could include preferred dividends, distributions, liquidation payments, voting rights, and dilution protection.

Another form of investment that I have seen to be popular is for an investor to provide a guaranty for the business. In this circumstance, the investor will provide a signature guaranty to a bank for the company to get a credit line. This involves no out-of pocket cash for the investor and provides needed liquidity for the company. As consideration for this, the investor will get a “guaranty fee” from the company, some equity, or both. The challenge on these deals is that they are usually for a fixed period of time (2-5 years), and it can be difficult to actually remove the guarantor from the line of credit if the company is still in debt. There are pros and cons of these various forms of investment that your advisors can help you think through in more detail.

I will be completing a review of the key points of a term sheet in my next column. For a sample term sheet, please email me and I will be glad to provide you one. Also, if you have specific questions regarding investing in business deals, please email me, and I will address in future columns. Investing in business opportunities can be a great diversification of your income and wealth; however, like anything else, you want to make sure that you are educating yourself and investing wisely.

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