October 31, 2019

A Term Sheet is Not a Deal, and What To Do About That

A good majority of signed term sheets with reputable investors lead to closed deals. But not all of them. That's why pretty much every venture capital term sheet includes a provision making it clear that both parties have no legal obligation to enter into the deal contemplated in the term sheet, or indeed any deal at all. Today, some thoughts on the more likely reasons for such post-term sheet deal deaths – and what entrepreneurs and investors can do to avoid at least some of them.

Syndication Failure

The first clue that a term sheet might not deliver the goods is the quality and commitment of the investor that proffered it. How well established and regarded is the investor, and how large a portion of the prospective financing is it signing up for? If you're talking about Blue Blood Ventures, and they are committed to taking all the way up to the entire round, the chances of syndication failure are nil. If, on the other hand, the lead is Acme Ventures, and they are committed to taking less than one-half of the total round, the chances of syndication failure are significant. As in, by my experience, maybe fifty percent or more.

As an entrepreneur, the key with syndication failure risk is recognizing it and incorporating that recognition into your thinking about even entering into the term sheet. In the Acme Ventures scenario, above, the entrepreneur should first consider whether entering into the term sheet is a good idea in a reputational sense. Other investors, if the deal does fall through, might see your entering into such a weak term sheet as reflecting poorly on the quality of your deal. Beyond that, the weaker the term sheet, the more careful you should be about including an enforceable "no-shop" term constraining your ability to seek alternative investors for any period after the term sheet is signed.

"October Surprises"

One common, and often avoidable, reason for term sheet failure is the "October (due diligence) Surprise." I've seen many cases where an entrepreneur gets so fixated on getting

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the term sheet done that he conveniently avoids or glosses over important deal warts in his efforts to nail down the term sheet. This is almost always a big mistake. Waiting until after the engagement, so to speak, to reveal the ugly birthmark in effect doubles down on the impact of the birthmark on the suitor, who now has to deal not only with the blemish but also with the character reveal associated with trying to gloss it over.

The lesson here is simple. If you think there's a blemish in your deal that your prospective investor might find significant do yourself a favor: make sure they know about it before they pop the question with a term sheet. The worst that can happen is that it kills the deal. That's bad, but not nearly as bad as the deal getting killed by the same revelation sometime after the term sheet is signed. At that stage, even in the best case, you've got some explaining to do when you get back on the investor dating circuit.

Overlooked Terms

A close cousin of the due diligence failure, the overlooked term blunder is equally avoidable. In this case, one party (perhaps surprisingly, often the investor) glosses over, at the term sheet stage, problematic issues that it hopes can be finessed in the run up to closing. Maybe even "buried in the fine print" (which now and again happens: one of the many reasons entrepreneurs should work with lawyers that know from experience where to look for such things).

By way of example, I've been involved with several term sheet fails where the issue was founder vesting. More particularly, an investor's post-term sheet insertion of a term subjecting some previously vested founder shares to new vesting requirements post-closing. The concept may have been perfectly reasonable in these cases, but the presentation – buried in the documentation produced after the term sheet was signed – can easily windup killing the deal. And, even if doesn't kill the deal, it will almost certainly damage the founder/investor relationship.

The lesson here, as the lesson in the Due Diligence Surprise case, is simple. If either party has any sense that the other party might view a term as important (and surely adding vesting terms applicable to founders meets that standard) make sure to get it on the table at the term sheet stage.

Chemistry Breakdowns

The founder/investor relationship is complex and almost always stressful. Even the best founder/investor marriages have their difficult moments, and most such relationships are not "the best." One common stressor is the very process wherein a term sheet morphs into a closing. It's a period where the investor (and the investor's counsel and other advisors) are engaged in activities (business and legal due diligence) the very nature of which is to question the founder's presentation of himself and his startup. It should hardly be surprising that some founder/stressor engagements, as wedding engagements, fall apart before the big day.

The Chemistry Breakdown can be ugly, but perhaps not always avoidable. But for me, it's better to find out before the big day that a relationship is failure prone than after. So, my advice here for entrepreneurs and investors is to remember why they signed the term sheet, and what they liked about their betrothed, when they encounter potholes on the road to closing. Having said that, my further advice is that if you can't stay friends from term sheet to closing, the prospects for staying friends in the years post-closing are not very good.

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Exploding Ducks

It was a peaceful Sunday morning at a local park. Ducks were swimming about in the pond, when one of them began paddling faster in preparation for flight. My eyes were fixed on it as it left the water, and … promptly exploded. There were feathers everywhere. There were no hunters to be seen. What happened?

It took me a while to come up with a plausible (if not certain) explanation for the unfortunate duck's demise. (A swallowed blasting cap.) But it was definitely an ex-bird.

Deals, like ducks, can explode. Exogenous events (say 9/11 or, more speculatively, a Chinese takeover of Honk Kong) can sink deals. (In the 9/11 case I was involved with a couple of them.) Endogenous events can also sink deals. In my experience a deal cratered because the partner running the deal for the investor quit.

There's not a lot you can do to prevent the odd duck from exploding. There is one thing, however. Once the term sheet is signed, move with all deliberate speed to closing. (One trick for entrepreneurs here: put an aggressive time limit on any term sheet no-shop clause.) Look at it this way: entrepreneurs that closed deals on 9/10/01 were in for a wild ride whereas many of their otherwise comparable peers planning closings for 9/12/01 were left without any ride at all.

A Few Closing Thoughts

When reputable investors sign term sheets with honorable investors, it's more likely than not the deal will get done. But nothing is a sure thing in what after all is a high-risk/reward business. A review of common reasons post-term sheet deals don't get done suggests that at least some of those failures could have been avoided. To the extent entrepreneurs and investors can manage those factors, and at least avoid the breakdowns happening in the more expensive post-term sheet period, they are wise to do so.

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Paul Jones
Of Counsel
pajones@michaelbest.com
T 608.283.0125