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Funding Round Term Sheets

An introduction to the key provisions typically included in funding round term sheets

# Introduction

## What is a term sheet?

A “term sheet” is a document that sets out the key “high level” commercial terms that the parties agree will govern a proposed legal commitment. Term sheets are rarely legally binding (save for certain provisions, such as confidentiality clauses) and need not be in any particular format; terms could be set out in an email, or in a more detailed document that is signed by the parties.

In the context of funding rounds, the content of a term sheet will depend on the nature of the particular investment, but terms sheets typically include provisions covering valuation, shareholdings, investor rights and protections, founder rights and obligations, vesting provisions and confidentiality.

## Why draft a term sheet?

Drafting a term sheet can save parties time and reduce legal expenses, as doing so will mean the parties have to consider, discuss, negotiate and agree the key terms upfront before professional advisers are brought in (although lawyers are sometimes engaged to help negotiate a term sheet on their client’s behalf). Essentially, the more detailed the term sheet, the less negotiation required when drafting the corresponding legally binding document(s).

A well-drafted term sheet can then form the basis of a more detailed, legally-binding shareholders’ agreement/investment agreement. During the drafting process, a term sheet operates as a check list of rights, obligations and protections that must be included, which can mitigate the risk of important elements being missed or neglected further down the line.

## The process

A term sheet is usually prepared by the investor(s) or the investee company, depending in part on the dynamic/negotiating power underpinning the relationship between the parties. In early stage and pre-seed funding deals, a term sheet might instead be prepared by the company raising the finance. Once the key terms have been negotiated and agreed, the investors’/company’s lawyers will then prepare the substantive legal transaction documents, mirroring the terms set out in the term sheet.

# Investor protections

## “Down round” protection

* Down rounds involve companies offering shares to prospective investors at a lower price than the price previously paid by existing investors (i.e. a “down round” is a funding round at a lower valuation than the previous funding round).
* “Down round protection” is typically sought by venture capital firms and investors participating in later stage funding rounds in order to limit the dilution of their shareholdings should a down round occur.
* There are a number of anti-dilution mechanism that operate to protect an investor on a down round. These vary in terms of how much protection the investor is offered (with a full ratchet providing maximum protection) and the formula for calculating such a mechanism should be considered carefully to assess its impact on future funding rounds.
* By way of example, if an investor invested at a valuation of £50 million but the company subsequently undertakes another funding round at a lower overall valuation (e.g. a £25 million valuation), a down round protection provision could entitle the investor to receive additional shares for free or at a reduced rate in order to compensate for the new, lower valuation.

## “Senior” share rights/most favoured nation provisions

* Early stage investors may require the company to agree in advance to extend to them in the future any more favourable rights that are granted to subsequent investors. This point is highly negotiable however and investee companies will usually try to push back on this.

## Director/observer appointment rights

* Investors may request the right to appoint a director or a board observer in order to exercise some degree of control over or monitor company decisions. This is fairly market standard for investors acquiring at least 8% - 10% stakes in companies.
* Where there is a group of small investors with a combined shareholding of 8-10%+ in aggregate, they may also ask for the right to appoint a director or board observer on behalf of the group.

## Investor approval rights

* The parties may agree a list of certain matters (known as “reserved matters”) that may not be decided without investor approval (or approval from a majority of the investors). This mechanism ensures that founders do not have full, unrestricted freedom to run the company how they see fit.
* Reserved matters typically include: founder salaries/bonuses, share allotments, the sale of assets outside the ordinary course of business, the amendment of a company’s articles of association (e.g. to introduce new classes of share) etc.

## Warranties

* Term sheets for investments into very early stage businesses will typically include only warranties relating to the legal status of the investee business and the investee’s legal right to enter into the proposed transactions.
* However, investors providing funding to more established businesses are likely to require a more substantial set of warranties, including warranties relating to (for example) intellectual property, employees, litigation, taxation, outstanding disputes and the company’s group structure.
* Where more substantial warranties are given, these will typically be qualified by limitations that cap the investee company’s potential liability to investors in connection with those warranties.

## Restrictive covenants

* Term sheets will typically set out a series of agreed restrictive covenants that will bind the founders and key employees of the investee business (these restrictive covenants may supplement or restate restrictive covenants already included in their employment contracts).
* During their tenure at the company and for a period of time after they leave, Founders will typically be required to refrain from setting up competing businesses, working for competitors, and soliciting employees, suppliers or customers.

## SEIS/EIS

* If a company secures “SEIS/EIS” status, this can give rise to significant tax benefits for investors. Before securing SEIS/EIS status, companies can opt to obtain “advance assurance” from HMRC that shares issued in the future will qualify for SEIS/EIS status.
* A term sheet may state that the company must use its reasonable efforts to obtain SEIS/EIS “advance assurance” from HMRC and continue to use its reasonable efforts to comply with on-going SEIS/EIS-related requirements.

## Liquidation preference

* Investors may require preference shares that afford them the right to be repaid their initial investment amount (or a multiple of such amounts) out of the company’s assets on an exit or liquidation in priority to other shareholders. Ordinary shareholders’ initial investment amounts would only be reimbursed once all preference shareholders have been repaid (if there are any assets remaining). In early stage investments, liquidation preferences should be resisted.

## Anti-dilution

* Investors may request that their shareholding percentage will remain the same across future funding rounds, even if they provide no further funding. Such anti-dilution provisions are almost always resisted by founders/investee businesses.

# Restrictions on founders’ shares

Investors will usually propose one or more restrictions that will apply to founders’ shares in order to lock founders into the company for a certain period of time once the investment round closes. As investors tend to invest in the *founders* as much as the business – especially in the case of early stage businesses – the restrictions set out below are fairly market standard.

## Good leaver/bad leaver

* “Good Leaver” and “Bad Leaver” provisions can determine what happens to the shares of an employee shareholder if their employment terminates. These provisions are usually included to incentivise key employees to remain in place, for example the founders and senior managers.
* The circumstances under which a person’s employment terminates will determine whether they are to be classed as a “Good Leaver” or a “Bad Leaver”. The parties can define these categories however they see fit and can even add further categories (for example, “Intermediate Leavers” or “Very Bad Leavers”).
  + Generally speaking, “Good Leavers” are employees who remain with the company for a specified minimum period of time or whose employment ceases by reason of retirement, serious illness or death.
  + In contrast, “Bad Leavers” tend to be employees who either resign before working at the company for a long enough period of time or are dismissed for cause.
* The implications of being a Good Leaver or a Bad Leaver depend on what is agreed between the parties. Typically, a “Good Leaver” may be entitled to retain a proportion of his or her shares, and will be entitled to transfer the remaining shares for their market value at the date of departure (i.e. if the market value has increased since the leaver originally became a shareholder, they will benefit from this rise in value). In contrast, a Bad Leaver is usually required to transfer all of their shares for nominal value (or market value if this is lower).

## Reverse vesting

* “Reverse vesting” provisions usually involve the company issuing shares to employees upfront (or allowing founders to retain their shareholding at the outset), but reserving the right to claw-back some or all of those shares if the employees fail to satisfy certain requirements.
* Typically, the longer an employee remains at the company, the fewer the number of shares the company can buy back if the employee decides to leave, which (as with good/bad leaver provisions) can protect investors by “locking in” founders and other key employees.

## Share transfers

* Term sheets will typically include a restriction on the ability of shareholders to freely transfer their shares to third parties. For example, a shareholder wishing to transfer their shares may have to first offer their shares to existing shareholders.
* As well as share transfers to existing shareholders, there will typically be a list of other common scenarios that would permit shareholders to transfer their shares to third parties. For example, investors may require the ability to transfer their shares to other group companies, whilst individual investors may require the right to transfer their shares to their immediate family for bona-fide tax-planning purposes. Transfers will also be permitted (or even required) if “good leaver/bad leaver” provisions come into effect (see below).

# Valuation

## “Post money” vs. “pre money” valuation

* The parties will need to agree at the outset: how much money the company is aiming to raise; how much equity this will represent; and the price per share.
* A “pre-money” valuation refers to the investee's agreed valuation before it receives its next round of financing; in contrast, a “post-money valuation” refers to the investee’s agreed value immediately after it receives the funds provided following a proposed funding round.
* It is important that the investee is clear on whether the investor is offering funds at a particular “pre-money” or “post-money” valuation, as this can significantly affect the investor’s shareholding percentage.
* It can also be worth agreeing what the company’s capitalisation table will look like post-investment and including this in the term sheet for clarity.

# Other key terms

## Drag-along

* “Drag along” provisions protect majority shareholders by stipulating that minority shareholders can be forced to sell their shares if the majority shareholders want to achieve a full exit. The minority shareholders will be “dragged” into the sale and will be required to sell their shares on the same terms and at the same price as has been negotiated by the majority shareholders for the sale of their own shares.
* Parties may want to agree in the term sheet what percentage of shareholders need to be in favour of a sale in order to “drag-along” the remaining minority, however typically a drag will operate if more than 50% of the shareholders wish to sell.

## Tag-along

* “Tag-along” provisions protect minority shareholders by stipulating that majority shareholders can only sell their shares (or a specified portion of their shares) if the minority shareholders are also offered the opportunity to sell their shares on the same terms and at the same price. Essentially, the minority shareholders are given the right to “tag-along” with the majority shareholders.
* As with drag-along provisions, parties may want to agree in the term sheet what percentage of shareholders need to agree to a sale in order to trigger the right for minority shareholders to “tag-along” on the sale. Typically, tag-along provisions will operate if more than 50% of the shareholders are selling their shares.

## Employee Incentive planning

* Term sheets may include agreed courses of action that may/must be taken in order to incentivise key employees, for example the establishment of an employee option plan.
* More detailed term sheets could specify details of such option plans, for example how many shares may be allotted under the plan, who will dilute when options are exercised, whether the plan will be “EMI” compliant etc.

## Confidentiality

* Term sheets may broadly define the scope of the confidentiality obligations that each party will adhere to once an investment agreement or shareholders’ agreement is drafted. Because such agreements need not be publicly disclosed, the parties may want to include detailed confidentiality provisions that make reference to the operations of the business and even sensitive commercial information.

## Diligence costs/exclusivity

* On larger funding rounds, investors will usually require exclusivity over the proposed deal before committing to due diligence (typically for a period of 90 days).
* Founders will customarily be liable to pay the investors’ legal costs if those founders pull out of the deal (as well as their own legal fees). Large investors can sometimes use this, coupled with the fact that any exclusivity granted may have deterred other prospective investors from participating, to leverage better deal terms late in the exclusivity period (in the knowledge that the founders will not want to pull out because of the consequences in respect of legal fees).
* Prospective investee companies will therefore try to include a provision that releases their liability to pay the investor’s expenses if the investor attempts to materially alter the terms of the deal.

***This short guide has been prepared for directors and owners of private limited companies for information purposes only, in particular to provide a summary of the key provisions typically included in term sheets in the context of funding rounds. This guide does not constitute legal advice and should not be relied upon as such for the provision of legal services. This document is subject to any engagement for legal advice. For specific queries and any further information, please contact Ignition Law for advice relating to your particular circumstances.***

For further information, please feel free to contact us.

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