



## EDUCATIONAL NOTES FOR CONVERTIBLE LOANS

April 2017

### 1. Issuer

#### **Name (the “Corporation”)**

Every term sheet starts with listing the full legal name of the entity that is selling or issuing the shares as outlined in the term sheet. This is a defined term and the name of the company will therefore not return later in the term sheet, we will see references to “Company” or “Issuer” only.

### 2. Business

#### **The Corporation is a [City]-based [Insert brief description of business].**

The second clause in a term sheet makes it clear what the business the Company or Issuer is active in. The key purpose here is to let the reader know instantly what the business is about and help the reader frame his or her point of reference when assessing the terms sheet. In other words, an investor will typically read through the remainder of the term sheet with a certain perspective if he or she knows that the business is a software, medical device, cleantech or biotech company. It is also the opportunity to insert a geographical location that will further help in the full evaluation of the term sheet. The description however can and should be very short.

#### EXAMPLES

*“ The Company is a Vancouver-based developer of mobile applications “*

or

*“ The Company is a Toronto-based manufacturer of medical devices with offices in Toronto and Calgary “*

### 3. Financing

**The Corporation is proposing to borrow through a convertible loan of no less than \$[1,000,000] (the “Convertible Loan” or the “Financing”) from a group of lenders (the “Lender” or “Lenders”).**

This is the central clause of the term sheet that describes the size of the convertible instrument that is offered. The reader at this point will know exactly what the company needs in dollar terms, where they are located and what business they are in.



Note how the Company makes it clear that this is a minimum offering. This is an essential point for the lenders and can make or break a deal. The size of the required loan is based on what the business plan has informed the company they need to achieve certain milestones, they can be both commercial and/or technical. What is important for the lender



to know is that with this statement the company signals that it has a certain level of confidence that with the amount of funds raised as indicated it can get to the next stage and will have sufficient cash to get there, at which time a subsequent financing round may be planned or the company will be cashflow positive and has no need to further raise financing.

Very often a convertible loan is used as a bridge to a future financing and the company should be asked about its ability to reach this next milestone with a current financing. “A bridge where to?” is an often heard and fair question in such circumstances.

What is equally important in assessing a convertible financing is how it will convert to equity and the lender will need to make an informed decision of the likelihood that the company has a road to conversion.

At the same time investors/lenders will have to assess if a convertible instrument is in the best interests of the company and its investors/lenders. Why has the company decided to do a convertible loan structure and not an equity financing?

**Good Practice:** The right approach to this is to have a designated lawyer to collect lender cheques and only allow the company to cash them once the minimum amount and all other conditions as specified in the term sheet have been met by the company on the date specified in the term sheet (see next). It should be noted that given the very early stage of some companies that adapt a convertible note, they probably will dispense with a minimum amount and collect convertible cheques as they go. It is therefore not uncommon to see a ‘rolling close’ when using a convertible loan.

**Note for Founders:** It will be in the founder’s interest to get funding as soon as possible. This is an area where founders and investors will have to understand each other objectives fully and may require some flexibility in order to get to closing.

#### 4. Close Date

**The Financing will close on or about [Date] (the “Closing Date”), on which date the Corporation and the Lenders will execute one or more Convertible Loan Agreements.**

Closely tied to the minimum sizing of the Offering is the Closing Date. Most companies will indicate the date they prefer to have the funds in the bank, giving a sufficient amount of time between the date the term sheet is presented to lenders and the closing date so that the minimum amount can be raised, lenders can do due diligence and lawyers can paper the transaction. Generally, closing dates as set by companies are wildly



optimistic and it will be prudent to allow for a date that gives all parties sufficient time to complete the necessary tasks.

Given the mismatch between companies' expectations and the realities of closing an investment round, many companies will resort to a 'rolling close' which essentially means they will cash investor cheques as they come in. This is a potentially lethal approach as business circumstances can change and a Company may not be able to reach the minimum required amount if it opts for a 'rolling close'.



**Good Practice and Note to Founders:** See above under ‘Financing’. A rolling close approach may be adapted, but it is advisable to set an ‘end’ or ‘closing date. A sufficient window of say 30 to 90 days to collect subscriptions may be the most appropriate approach here.

## **Section 5. Use of Proceeds**

**The Corporation will use the net proceeds of the Convertible Loan to complete the first release of its product, fund marketing activities and general corporate purposes.**

In light of the above it is recommended to include what the funds are to be used for, note that this is only a general description but it gives the investor some clarity as to where the funds raised will be deployed. Note that a detailed description is outside the scope of a term sheet and the investor should refer back to the business plan and financial projections that the company provides in order to test their validity and appropriateness.

### *EXAMPLE*

*“ The Company will use the net proceeds of this Offering to complete the first release of it mobile platform, fund commercial activities and general corporate purposes “*

**Good Practice:** Investors should always ensure that the numbers presented in the term sheet tie back to the business plan and that there are sufficient funds to allow the company to achieve its milestones. It is also useful to ensure what relatively vague description like ‘general corporate purposes’ means. Some companies are inclined to have relatively high corporate overhead costs like rent and salaries and they tend to come under ‘general corporate purposes’. The investors or lenders should ensure that they are comfortable with company’s approach to fiscal management. Note that under ‘Information Rights’ there is a set of tools available to check into past and future financial; performance of the company.

**Note for Founders:** Investors will expect a detailed budget to ensure that their funds will be spent appropriately. This will need to be substantiated in the due diligence materials and also be available for future years.

## **Section 6. Capitalization**

**The Corporation’s share capital consists of common shares (“Common Shares”) and options to purchase Common Shares (“Options”) [describe other classes of shares, if any]. As of the date of this term sheet, the Corporation has [2,000,000] Common Shares**



**issued and outstanding, [200,000] Options are reserved under the Corporation's Share Option Plan (of which [150,000] have been granted).**

There are no other securities of the Corporation outstanding. A capitalization table is attached as a schedule to this term sheet.

Although the lender/investor will purchase a convertible loan, this section is important as it will explain what the lender/investor's ownership position will be upon conversion, the mechanics of which are outlined in Section 9. Upon reading this section the lender/investor



will know exactly what a participation in the Convertible will mean in terms of ownership in the company once the loan converts. Given the stage of the company and the fact that a convertible instrument is used it is very likely that there will only be founder shares and possibly some share options issued.

## **Section 7. Maturity Date**

**The maturity date will be [●] months from the Closing Date which is [Date] (the “Maturity Date”). Principal and unpaid accrued interest on the Convertible Loan will be due and payable on the Maturity Date.**

This is the date on which the loan matures, in other words: if no conversion has taken place the loan amount plus accrued interest becomes due and payable. The question then becomes: what if the company does not have sufficient funds to repay the loan? Or: does it convert and do we have enough data points to negotiate such a conversion? The answer here is that this is the point where the lender/investor is in control and will likely initiate a negotiation with the company on the next steps.

The outcome of this will be driven by the state of the business. They may or may not have sufficient funds to repay the loan, based on the state of affairs it may be possible to agree on a valuation and convert the loan or the term of the convertible loan may be extended to a future date in return for an amendment of the terms like an increased interest rate and/or an amended conversion mechanism. Depending on the circumstances, a simple extension of the convertible loan agreement without amending its terms may often be the best solution.

**Capitalization Table and Note for Founders:** a cap table or a summary thereof should be attached to the Term Sheet. The company can put one together using Excel of Numbers, another recommended option would be to use Captable.io which is a free online tool (this is a US tool, so note the use of the word “stock”, where in Canada we use “shares”, but is still an excellent way to do scenario building). A company that issues a convertible loan will in most circumstances have a very simple cap table, but it is still advisable to have one ready if only to calculate what an eventual conversion of the loan looks like.

## **Section 8. Interest**

**[6-8 is the normal range]% per annum. Interest will accrue, be compounded and calculated monthly, and may be converted into**



**Common Shares of the Corporation on the same terms as the principal.**

As it is a loan, convertibles have an interest coupon, which usually ranges from 6 to 8% annually. Generally the interest accrues and is converted together with the loan principal on the date of conversion.

The company will have to capture this in its accounting system and the balance sheet will reflect the total amount of the convertible loan outstanding, including accrued interest.



**Note for Founders:** For founders it will be important to note that even though a range of 6-8% may not seem much, it tends to add up if the interest is accrued over time and converted at a future point in time. When modelling financial projections founders will have to make sure to include interest payments under all instruments that convert and assess what the impact is on common shareholders in the future.

## **Section 9. Conversion**

**(A) If the Corporation completes a private placement of equity securities for gross proceeds of at least \$[1,000,000] in one or multiple closings (excluding any indebtedness converted pursuant to the Convertible Loan) (a "Significant Financing"), then at the closing of such Significant Financing all of the Convertible Loan and accrued interest (together the "Conversion Amount") will be automatically and concurrently converted into equity securities of the same class as those issued in the Significant Financing at a price equal to the lower of:**

- (i) the price paid per equity security in the Significant Financing; and**
- (ii) the pre-money price per equity security (on a fully diluted basis) of the Corporation assuming a pre-money valuation of CDN\$[●](the "Capped Price"),**

**less a [10 - 30]% discount to the final conversion price, and otherwise on the same terms and conditions as the investors under the Significant Financing.**

**(B) Upon an amalgamation, merger, reorganization or sale of shares of the Corporation which results in a change of control, an initial public offering of equity securities of the Corporation or a sale of all or substantially all of the Corporation's assets (each a "Change of Control"), the Conversion Amount will be automatically and concurrently converted into the senior most class of issued and outstanding shares of the Corporation at a price equal to the lower of:**

- (i) the price per the senior most class of issued and outstanding shares of the Corporation based on the valuation given in connection with the event triggering the Change of Control; and**
- (ii) the Capped Price,**

**less a [10 - 30]% discount to the final conversion price.**

**(C) The Conversion Amount may also be converted into the senior most class of issued and outstanding shares at the Lender's sole**



**option at any time prior to the Maturity Date (or after the Maturity Date unless previously converted or repaid in full) at a price equal to the lower of:**

- (i) the lowest price per the senior most class of issued and outstanding shares of the Corporation based on the valuation given in its most recent external equity financing; and**
  - (ii) the Capped Price,**
- less a [10 - 30]% discount to the final conversion price.**



***Note: in the case of (C) if no 'price' can be established, the Corporation and Lenders will have to refer a valuation decision to an independent third party evaluator to establish a fair market value (FMV) for the Common Shares in order to determine the conversion price.***

***It may also be useful to provide for automatic conversion of all indebtedness under the Financing if approved by a majority-in-interest of all Lenders.***

***Optional:***

***(D) The Conversion Amount will automatically be converted into Common Shares on the Maturity Date at a price equal to the lower of:***

***(i) the lowest price per share of the Corporation based on the valuation given in its most recent external equity financing; and***

***(ii) the Capped Price,***

***however, where no such external equity financing has occurred after the Closing Date, the price will be the Capped Price. An external financing is a financing which includes investors other than the current directors, officers and employees of the Company completed after the Closing Date.***

***less a [10 - 30]% discount to the final conversion price.***

This section of course is at the heart of any convertible term sheet as it outlines under which circumstances and at which price the loan will convert to equity. There are three key events that prompt a conversion:

1. A 'Significant Financing' is closed by the company, usually of a size that is large enough to establish a proper valuation.
2. The company is acquired or merges, a 'Change of Control', at which point again there is a value established and there will be no point in holding on to the convertible.
3. The lender exercises his or her right to convert, this would be a 'Voluntary Conversion' in his or her sole discretion.

A fourth one would be an 'Automatic Conversion' at maturity, this mechanism would kick in if none of the three earlier conversion scenarios have taken effect. Note that we list this as an option and fourth conversion term, the parties may agree to not define this and defer the negotiation about this to the future in the interest of time.

At the conversion date, the following mechanics will determine the price at which the loan and accrued interest converts:



1. The price per share which will in most cases be equal the price established by the financing round or the acquisition/merger;
2. A valuation cap entitles lender/investor to convert into equity at the lower of the valuation cap or the price in the subsequent financing. In other words, a 'cap' protects the lender/investor from a valuation that is far higher than would have



been the case had they invested their funds as straight equity. In a way this embeds a share valuation in a convertible note, which was conceived to avoid any valuation discussion! Originally most convertible notes did not have 'caps' but they came into practice once it became clear to lenders/investors that if company's performed very well it would negatively impact the conversion rate of convertible noteholders.

3. The final piece of the pricing puzzle is what effectively provides the bonus lenders/investors get (apart from interest) for participating in a convertible structure: a discount to the share price at which the convertible loan converts. Normally this ranges from 15 to 30% and is determined in a negotiation between the company and the lenders/investors. As a general rule, the shorter the term of the convertible note and the less risky the investment, the lower the expected discount.

### **Section 10. Prepayment**

**The Corporation does not have the right to prepay any indebtedness without the prior written consent of each Lender or, but may prepay all indebtedness under the Financing with approval of [•%] of the Lenders.**

Under certain circumstances, the company can prepay all of the outstanding loan amount together with accrued interest. This is something that can work greatly in favour of the company if things are working out for them. Strong revenues and cashflow may enable them to pay out the loan without having to dilute their share ownership. This carries a significant risk for the investors/lenders so the terms of any prepayment clause will have to be the subject of negotiation and more often than not there will not be a separate prepayment section.

### **Section 11. Information Rights**

**The Corporation will provide the Lenders with the following:**

- (a) annual reviewed (or audited, if available) consolidated financial statements for the Corporation (including its income statement, balance sheet and cash flow statement) within 90 days of the Corporation's financing year-end;**
- (b) management prepared (in accordance with GAAP) quarterly financial statements within 30 days of the end of each quarter and accountant prepared year- end financial statements (audited if required by law, but if waived Notice to Reader at a minimum) within 90 days of each fiscal year end;**



- (c) quarterly management reports within 30 days of the end of each quarter;
- (d) a (board-approved) budget at the start of each fiscal year and any amendments thereto; and
- (e) any other document reasonably requested by the Lender.

*Optional:*



*(f) reports and updates that the Lenders may reasonably ask for from time to time;*

*(g) access to a metrics platform (Hockeystick, Klipfolio, Google Docs) to share regularly updated data (if appropriate for business); and*

*(h) monthly updates.*

**If a voting trust is in place this information will be shared with the trustee who will disseminate among the Lenders that are bound by the voting trust.**

One of the key issues for investors is to understand how they will be kept informed of the Corporation's progress and how they can quickly understand if things are not moving in the right direction and action is warranted.

**Good Practice:** The challenge in this area is that by the time an Investor receives Company information most events are well in the past. This in particular is an issue if things are not going in the right direction or certain crises emerge (cash crunch, milestones not met, large contracts cancelled). Companies often have a habit to under-report bad news and over-report good news. Some companies make use of online reporting tools (e.g. Klipfolio, Hockeystick, Visible) which track the company's key performance in real time and offer easy to understand dashboards that will tell how a company is doing.

It is up to the company and its investors to agree on the best communication tools which will include in-person meetings although it should be noted that company executives will not have the bandwidth to meet individually with each investor on a regular basis.

**Note for Founders:** A balance has to be found here between what a company can logistically report on a regular basis and what investors want and need to see. Founders may want to set up some systems and processes that will automate information sharing and thus reduce the time spent on this. Most of this information the company will have to prepare for internal purposes anyways. Note that if an employee exercises his or her share options, they will become a shareholder and be entitled to the same level of access to company information.

From time to time in person meetings with investors will be beneficial for both parties, a party or social event together with the AGM is also recommended.



## **Section 12. Events of Default**

**The Convertible Loan Agreement will include standard Events of Default provisions, including but not limited to insolvency/bankruptcy, material and unremedied breach of agreements, criminal offense or material breach of law that has a material effect on the Corporation, and failure to make any payment when due. Upon an Event of Default all of the Conversion Amount and obligations of the Corporation to the Lenders under the Convertible Loan will be immediately due and payable.**



These standard events of default will be described in more detail in the final Convertible Loan Agreement and give the investors/lenders the necessary protection in case things do not work out as planned.

### **Section 13. Vesting**

**All Common Shares and share equivalents (including options) issued to founders and certain other key persons will be subject to customary vesting provisions that, to the extent they are not in place, will be incorporated in founder and key person employment agreements, the execution of which will be a condition precedent to closing.**

Increasingly investors will want to ensure that the key executives and/or founders in the company will continue to work for the company to ensure its future success while ensuring they have a strong incentive to continue to do so. Vesting of shares is a key mechanism to accomplish this and in simple terms it ensures that the shares owned by a founder ‘vest’ over time, in other words the founder will not have full ownership until the vesting period has been completed. The vesting terms are normally documented in a founder’s employment agreement with the company, sometimes in the Shareholders Agreement.

And example would be:

*All Common Shares issued to founders shall be subject to vesting over an agreed term of four (4) years, with a 1-year cliff and a monthly vesting from the date of the first anniversary of the Closing.*

It should be emphasized that vesting is not only used as an incentive to founders and employees to stay with a company and perform, it is enables companies to recoup shares if people move on and allocate the shares so gained to new executives and/or employees.

**Good Practice:** From a company’s perspective it is good practice to have an agreed vesting schedule in place even before investors come on board. It will deal with intra- founder issues that may emerge regardless of having investors in the company and moreover it will demonstrate to outside investors that the company’s founders have pro- actively thought about this issue and dealt with it.

*EXAMPLE I*



*The most commonly used approach is to agree on a vesting schedule for shares that have already been issued and make them subject to a 'clawback' provision. In this way founder shares can (a) be voted and (b) benefit from the lifetime capital gains exemption under CRA rules. It is standard to let shares vest over 4 years (3 or 5 year vesting schedules are not unusual, often depends on the nature of the business and the negotiation between founders and investors) either by vesting an equal number of shares on a monthly or quarterly basis or cliff vesting. In a 'cliff vesting' a founder or employee becomes fully*



*vested at a specified time rather than partial monthly or quarterly vesting periods, ie. upon completion of 2 or 3 or 5 years of service.*

*In a 'clawback' or 'reverse vesting' scenario an employment or shareholders agreement will incorporate a schedule that will outline that the number of founder's shares that are subject to clawback over a period of time. This number would reduce as time moves on. If the founder or employee is terminated or leaves the company the board of directors would have the right to purchase back the shares that are still subject to vesting at a nominal price, say \$0.0001.*

#### **EXAMPLE II**

*In Quebec a somewhat similar approach is taken , although formulated differently as 'Restricted Shares'. Here is a clause from Angés Québec for consideration:*

*“ The Shareholders' Agreement will contain standard repurchase option of the shares owned by any Founder (for the purposes herein, the term “Founder” means each of and ) in case of death, bankruptcy, incapacity, termination without cause, termination for cause, material breach of the Shareholders' Agreement, unauthorized transfer of shares or seizure of shares. If any Founder resigns at any time prior to the fourth anniversary of the Closing Date, the Restricted Shares (as defined below) owned by any Founder are subject to the right of repurchase by the Corporation at the lower of: (a) the fair market value of a common share at the time of repurchase of such share; or (b) the subscription price of that common share. “Restricted Shares” means all of the Shares held by the Founder less 2.0833% of such shares, which shall cease to be Restricted Shares effective as of the last day of each and every calendar month over a forty-eight (48) month period commencing on the closing date of the contemplated investment. All of the shares held by such Founder that have ceased to be Restricted Shares are subject to the right of repurchase by the Corporation at the Fair Market Value “*

**Note for Founders:** As mentioned this is 'market'. The best way to address the issue is to pre-empt it and have vesting covered in employment agreements prior to engaging with investors. That way founders can address any investor concerns while implementing a vesting schedule that actually works for them. It may of course always be subject to a negotiation with the investors.



#### **Section 14. Due Diligence**

**This Term Sheet does not provide a description of material information sufficient to describe the business and affairs of the Corporation. Potential lenders may conduct such due diligence inquiries as they consider appropriate and will be provided**



**access, subject to standard confidentiality provisions, to material documentation and information concerning the business, the Corporation and its respective management and third party advisors. Lenders should, in conjunction with their professional advisers, make their own assessment of the merits and risks of any proposed loan to the Corporation.**

This section gives the investors the right to conduct due diligence and stipulates that the investors have full access to all company information and employees and that company will answer any and all questions that investors may have. The Term Sheet can include a fixed date by which Due Diligence should be completed although the Closing Date as referred to in Section 4 usually is deemed to be the date on which Due Diligence will be have been completed.

**Good Practice:** once the Term Sheet has been signed the investors will engage in Due Diligence and it is highly advisable that they ensure the company has a data room set up with all required information and data, preferably using an online sharing service like Google Drive, Dropbox or Box. It is advisable to have this ready early in the process and should include the following at a minimum:

1. **Investor Materials:** Business Plan, Slidedeck, Executive Summary
2. **Corporate or Legal:** Incorporation documents, Share Register and Articles of Incorporation as well as a Capitalization Table.
3. **Financials:** accountant and management prepared historical financials and budgets and forward looking projections (3 to 5 years ideally)
4. **Team:** Founder & Employee Contracts, team biographies and resumes
5. **IP:** Intellectual Property, Patents
6. **Tax File:** with recent tax filings and SR&ED documentation the company uses
7. **Business Development:** Sales Pipeline, Sales deck, Marketing collateral
8. **Commercial Contracts:** all material sales contracts, licensing deals
9. **Media:** press clippings, links to online coverage, reports from third parties
10. **Other:** any other relevant information

**Note for Founders:** Following the presentation to investors and the term



sheet negotiation, this is the company's chance to shine and make a lasting impression while ensuring that the dollars hit your bank account sooner rather than later. A properly constructed and populated due diligence folder as described above will help accomplish that.

### **Section 15. Closing Conditions**

**Closing of the Financing will be subject to customary closing conditions, including but not limited to:**



- (a) minimum Financing raised;
- (b) completion of due diligence;
- (c) execution of employee and key person employment agreements which include vesting provisions (if applicable), NDAs and IP assignment (and may include key person insurance);
- (d) appointment of board of directors;
- (e) confirmation that the Corporation is a Canadian Controlled Private Corporation (CCPC);
- (f) completion of all legal documentation and corporate minute book being up to date;
- (g) establishment of a [new] [amended] Share Option Plan; and
- (h) no material adverse change.

**A number of these are optional and will often depend on each situation, they will need to be negotiated in each investment case.**

There will be quite a few things that the investors will want to see in place before the funds are released to the company. It will be hard to cover all of them in the Term Sheet as there will be a significant number that come up during the due diligence phase, but the above is a selection of items that are fairly common.

**Good Practice and Note for Founders:** Note that given the stage of the company and that we are dealing with a convertible instrument here it may be that not all of these conditions are required and that the hurdle to close is far lower than it would be for common or preferred equity deals.

## **Section 16. Subscriptions**

**The Convertible Loan is only available to accredited investors and friends, family or close business associates, in reliance on an exemption from the prospectus requirements in Canada as outlined in National Instrument 45-106.**

**The minimum commitment is \$[50,000] per Lender. Individual commitments will not be scaled back in case of an oversubscription.**

It is important for all parties to understand how subscriptions are taken, ie. if there are more funds committed by investors than necessary will



the company oversubscribe or scale back?

**Good Practice:** The standard language is that subscriptions will be filled on a 'first-come, first serve' basis and that they will not be scaled back in case of an oversubscription. In



particular in early stage situations the practice is to ‘take money when it is on the table’ rather than risk a cash shortfall at a later date when fundraising conditions may be less favourable.

**Note for Founders:** It is important to ensure that the company complies with relevant securities regulations, this is something where lawyers can assist and advise. Again, having money on the table is a good thing so you might as well take it as market conditions may change rapidly, so there is no harm in taking over-subscriptions.

**Good Practice and Note for Founders:** The standard language is that subscriptions will be filled on a ‘first-come, first serve’ basis and that they will not be scaled back in case of an oversubscription. In particular in early stage situation the practice is to ‘take money when it is on the table’ rather than risk a cash shortfall at a later date when fundraising conditions may be less favourable. Note that in a convertible situation the subscription process may be more fluid than when dealing with share subscriptions.

### **Section 17. Documentation**

**On the Closing Date, the Corporation and the Lenders will execute and deliver Convertible Loan Agreements and such other documents as are necessary to complete the Financing.**

This section details what documents the investor is expected to sign upon completion of the due diligence phase. In most circumstances this will be a Convertible loan Agreement, possibly a General Security Agreement.

**Good Practice & Note for Founders:** None, this is standard stuff.

### **Section 18. Cost and Legal Counsel**

**The Corporation agrees to bear its own costs and cover the Investor’s legal costs up to a maximum of \$[●] in the aggregate.**

**or**

**Each party to this term sheet agrees to bear its own legal costs.**

Although in general – and in particular when using a standardized term sheet – companies and investors do not engage with formal counsel until such time a transaction is closed, it is generally advised to make clear who carries whose legal costs.

Upon closing the Corporation’s lawyers will draft and help execute the



Convertible Loan Agreement and General Security Agreement (if required).  
These costs will all be carried by the company

**Section 19. Confidentiality**



**The Corporation and the Investors will refrain from publicity and not disclose any information concerning this term sheet without the written approval of the other party, except as required by law and provided that the parties may disclose information to their accountants, legal counsel and other professional advisors.**

Term sheets will include a standard confidentiality undertaking which is different from a mutual confidentiality undertaking which the company and potential investors may have signed at the outset of their discussion and which will generally deal with all information (not just the deal terms) that the parties disclose while negotiating a potential transaction.

**Note for Founders:** Investors are increasingly unwilling to sign NDAs and you have to bear this in mind when disclosing company information. VCs have been unwilling to do so for many years and angels are just following market practice here. It is however advisable for both parties to ensure that deal terms remain confidential.

### **Section 20. Expiry**

**This term sheet expires at [Time] on [Date].**

In order to keep a transaction moving and keep pressure on the parties to make a deal happen most term sheets will expire on a specific pre-agreed date. More importantly, once expired it will give either party the right to renegotiate the terms of what was agreed.

**Good Practice & Note for Founders:** Investors will want to keep some pressure on a company and possibly change the deal terms once a term sheet has expired as it is quite likely that (market) information will have emerged that may impact their appetite for investment. Founders should be aware that term sheets go 'stale' if it takes too long to complete a deal and so it is recommended to agree on a time horizon that not only works for both parties, but that will ensure there is enough time to raise the required financing. It is best to minimize uncertainty.

### **Section 21. Binding Nature**

**Sections 17, 18, 19, 20 and 21 will survive termination of this term sheet.**

This section simply explains which clauses are binding and thus survive a termination of the term sheet. Normally these are Cost & Legal Counsel, Confidentiality, Expiry, Binding Nature and Governing Law clauses.



## **Section 21. Governing Law**

This is standard and essential term in which the parties specify that any dispute arising under the term sheet shall be determined in accordance with the law of a particular jurisdiction.

## **EXTENDED TERMS**



## **B1. Lenders**

**[Name] and other investors acceptable to the Corporation (collectively the “Lenders” and each a “Lender”). The Lenders will appoint a single investor to lead the Financing with the Corporation (the “Lead Lender”). The Lead Lender (in consultation with the other Lenders) shall finalize the terms of the Financing, as described herein.**

In investor-led deals the investors will insert this clause to outline who they are and what specific role they play and what rights they have. Term sheets that are company-led will generally not have this clause, it is therefore largely an optional one for lenders or investors to use if they prefer to.

**Good Practice & Note for Founders:** In Canada most rounds are company-led and will not require this clause, however there are situations where a ‘lead investor’ will pull a group together and insert this into the term sheet. Founders are to take note that the ‘lead investor’ will be driving the deal and that he or she will be driving the negotiations from a position of strength as it represents an underwritten offer from a likely cohesive group of investors.

## **B2. Security**

**The security offered to the Lenders will consist of the following:**

- (a) general security agreement from the Corporation providing a security interest in all present and after-acquired personal property, subject to permitted prior charges; and**
- (b) the postponement and subordination of all shareholders loans in favour of the Lenders.**

Remember, this is a convertible loan and as such the company has the obligation to repay the funds to the lenders/investors and if the loan does not convert and the company cannot repay, then the lender will have the right to enforce the security in order to seize the assets of the company. Think of this as one extra layer of protection for the lenders/investors that would not be available if they had committed their funds as equity investors.

That said, security is rarely enforced as most companies will be able to get to either a conversion or repayment moment and if not the likelihood that there are any assets of value (possibly some IP) against which security can be enforced is slim.



**B3. Exclusivity**

From the date of acceptance of this term sheet until the earliest of (a) the Closing Date or (b) the formal termination of negotiation by both the Lenders and the



**Corporation, the Corporation will not directly or indirectly solicit, initiate or participate in any discussions or negotiations with, or encourage or respond to any inquiries or proposals by any persons, Corporation or group other than the Lenders, concerning any financing or sale of the Corporation without prior approval of the Lenders.**

***Option: add a time limit to this period, e.g. 90 days.***

Exclusivity is sometimes used in investor-led deal to 'lock up' a company and avoid it going around shopping for better terms. It is however, in Canada, rare and we would recommend against using it.

#### **B4. Board of Directors**

**The Corporation's Board of Directors currently consists of two (2) directors. Prior to the completion of the Offering the Board of Directors shall be increased in size to three (3) directors, the investors in the Convertible Loan shall appoint one of the three directors.**

**Investors will have the right to appoint an Observer.**

It is rare to see investors demanding a board position in convertible loan financings although in theory it could be possible if the situation required this. In the latter case our general commentary about boards and observers applies:

It has become good practice for companies to disclose in the Term Sheet who serve on the Board of Directors. This not only serves as information about the people behind the company, it generally sets the stage for governance once the company has completed the financing. To that end this section will usually outline who will serve on the Board of Directors, or more specifically who on behalf of the investors in the Financing will serve on the Board going forward. This is the opportunity for investors to ensure that their voice is heard on a Board and ensure that the minority position they have is represented on the Board of Directors.

Note that in early stage seed deals this is often not invoked and a Board of Directors with outsiders often comes about in later rounds, notably Series A. That said in some investor-led deals there will be a requirement to nominate an investor representative to the company's Board and this clause can be used for that purpose.

**Good Practice:** In most early stage companies and prior to a first round of investment, the original founders usually form the Board of Directors. The first financing offers the opportunity to elect a group of Directors that not only represent the founders, but also other investors and in some case this



can be specified and negotiated in a term sheet. It is recommended that investors are satisfied that their interests are sufficiently represented on a Board of Directors.

In general a Board would consist of an uneven number of directors and range in size from anywhere between 3 and 5 directors at the earlier stages of the Corporation. Potential Directors should be aware of Director's liability, Director's compensation (mostly stock options and/or a per meeting fee) and the frequency at which board meetings are held. It



will also be important to understand what is expected of directors on an ongoing basis in terms of time commitment and contributions, including managing the expectation of committing further funds.

Most companies will purchase Directors and Officers Insurance (“D&O Insurance”) but this would have to be agreed with the new board and the recurring annual cost of it also has to be taken into account.

Investors may also ask to appoint an Observer to board meetings. This person does not have any fiduciary obligations or the right to speak during board meetings. The observer role merely functions as a ‘check’ on corporate proceedings to see what is going on. In practice observers tend to actively participate in board meetings and that may have some benefits if his or her contributions are productive.

**Note for Founders:** Ensure that your shareholding is well represented and that the best people on the founding team also take the board seat(s). If the board expands you may want to ensure that someone with an entrepreneurial background joins the board as such a person is often in a far better position to understand how a founder thinks and feels about certain issues. While a governance tool and a venue where other shareholders can be represented, founders should make a board ‘work’ for the company, it can help a company grow with great ideas, connections and in some cases actually roll up the sleeves and get stuff done. Do remember that non-founder board members will want to see some form of compensation (share options, per meeting fee) in addition to the D&O insurance. If funds are tight you can suffice with share options and an indemnification agreement.