START-UP SOLUTIONS by Beiruti

# The Expensive Mistakes Founders Make Before the Term Sheet Arrives

*Eight legal pitfalls seen time and again among founders building companies in Jordan and across the wider region*

Most startup legal problems are not dramatic. Nobody gets sued in year one. The damage is quieter: a structure chosen because it was quick, a promise made over coffee, a template signed because "everyone uses it."

The difficulty is that these decisions often sit dormant until the company is worth something, at which point they surface during due diligence, in front of an investor or acquirer who now holds the leverage. Fixing them at that stage almost always costs more, takes longer, and is negotiated from the weakest possible position.

With that in mind, we have set out below eight pitfalls we see time and again among founders building companies in Jordan and across the wider region. We have deliberately left aside the textbook issues that most founders have already read about, and focused instead on the ones that, in our experience, tend to cost real money.

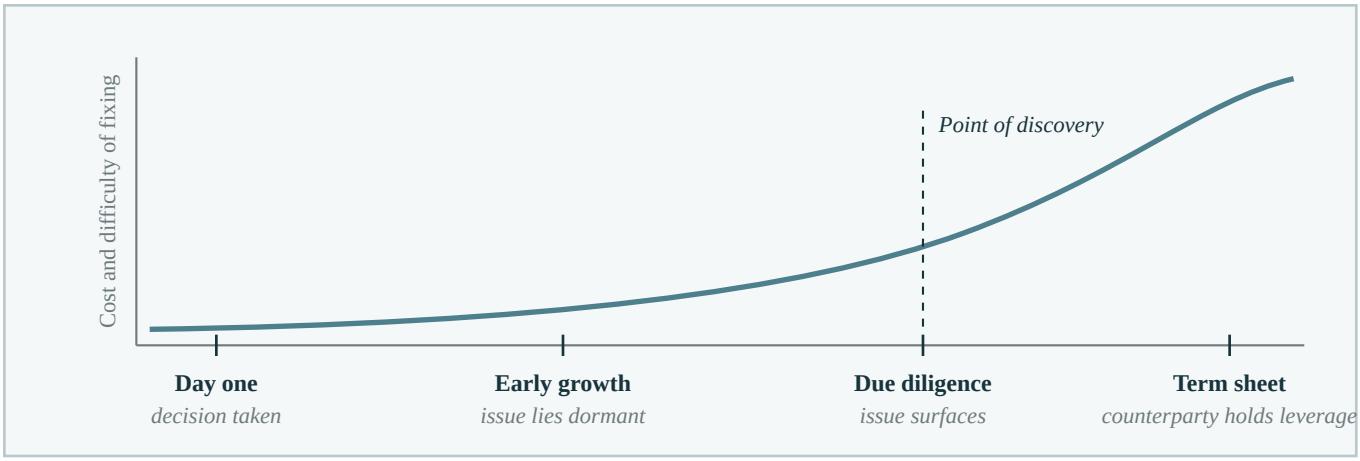



*Figure 1: How a small early decision becomes an expensive one*

01 / STRUCTURE & EQUITY

# Getting the foundations right

## 01

## Incorporating the company you will later have to undo

Many founders choose to incorporate a Jordanian limited liability company because it is quick, familiar and relatively inexpensive to set up. For a business that never intends to take on outside capital, that is often entirely the right decision. For a business that plans to raise venture funding, however, the LLC frequently turns out to be a structure that will eventually have to be unwound.

The reason is that institutional investors come to the table expecting a particular set of tools, namely share classes carrying different rights, liquidation preferences, anti-dilution protection, conversion mechanics, an employee option pool and transfer restrictions on

which they can actually rely, and the LLC was simply never designed to accommodate that toolkit. The private shareholding company offers considerably more flexibility in this respect, although it is worth bearing in mind that many regional funds will in any event ask for a holding company in ADGM, the DIFC or another offshore jurisdiction.

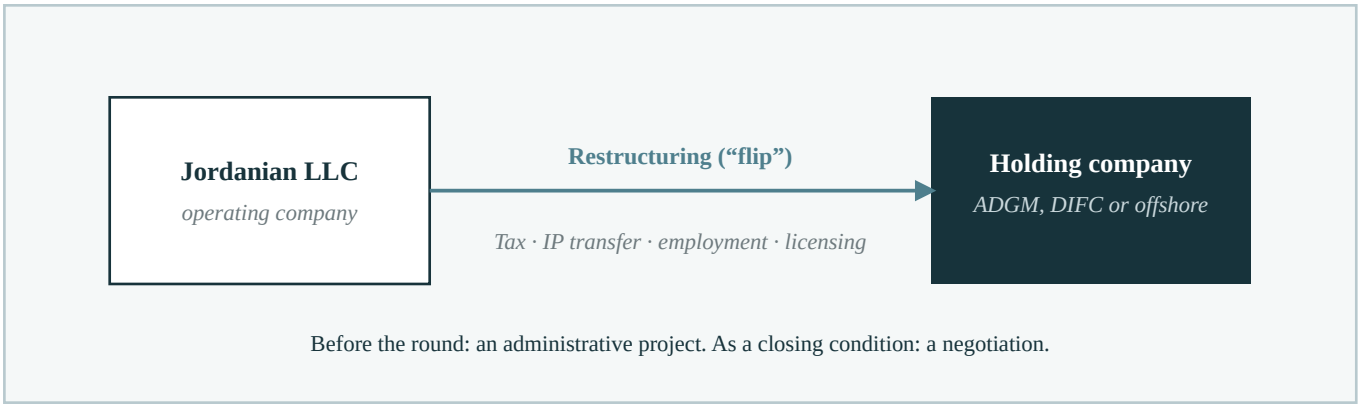



*Figure 2: Restructuring into a holding company, before and during a round*

Where founders really get caught out, though, is on timing. A restructuring done calmly before a round is an administrative project. The same “flip” done as a closing condition, with a term sheet on the table and runway shrinking, raises tax, IP transfer, employment and licensing questions all at once, and every open question becomes a negotiating point for the other side.

## 02 Founder equity that nobody can take back

Splitting the equity equally between co-founders on day one understandably feels like the fair thing to do. Doing so without any vesting, however, is precisely how a co-founder who walks away in the eighth month can end up owning a third of a company that the others then spend the next five years building.

Investors tend to notice this immediately, because “dead equity” of this kind weighs heavily on the capitalisation table, and their usual response is to require all of the founders to re-vest their existing shares as a condition of the investment, on terms that are, unsurprisingly, set by the investor rather than by the founders themselves.

On top of this, there is a local dimension that imported templates generally overlook. Reverse vesting is usually structured as a call option over a departing founder’s shares in favour of the remaining shareholders, and that option is typically set out in a shareholders’ agreement. Under Jordanian law, however, such an agreement binds only the parties who signed it, whereas the company and the Companies Control Department act on the basis of the registered constitutional documents; moreover, share transfers must follow statutory formalities and, in some company forms, are subject to statutory pre-emption rights. As a result, a vesting clause that reads perfectly well in English can prove

surprisingly difficult to enforce against a departed founder who simply declines to sign the transfer.

**LOCAL DIMENSION**

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02 / INTELLECTUAL PROPERTY

# What the company actually owns

## 03

### Intellectual property the company does not actually own

Ask a founder who owns the core technology and the answer is almost always “the company.” Ask for the documents that prove it and the answer changes.

The usual gaps are predictable: code written before incorporation, which belongs to whoever wrote it; work by freelancers and offshore developers engaged without a written assignment; contributions from a co-founder who never signed anything; and work created while a founder was still employed elsewhere, or at a university whose policies claim it.

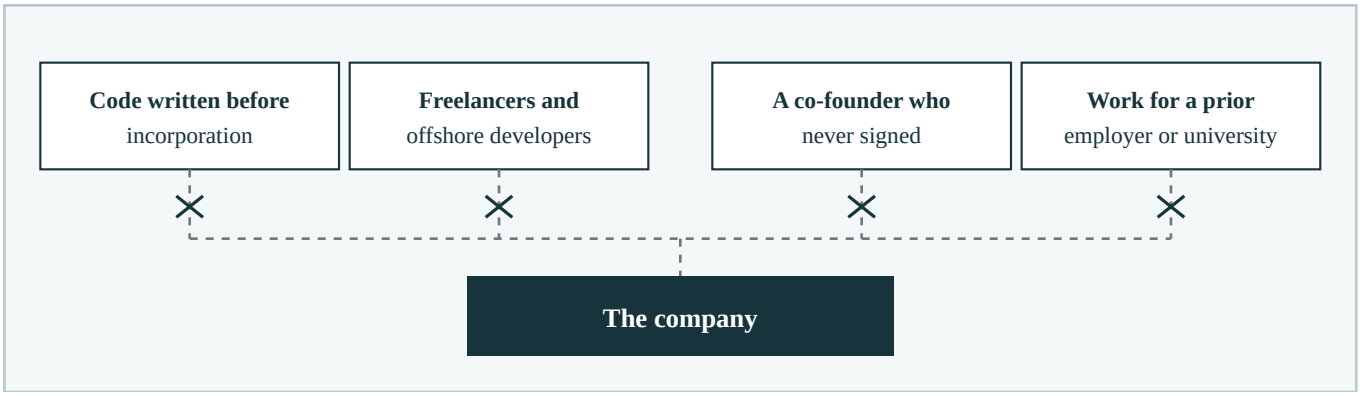



*Figure 3: Where the chain of title most often breaks*

Civil-law systems add a further subtlety here that US-style templates routinely miss. While the economic rights in a work can be transferred, the transfer generally has to be made in writing and has to specify the rights, the scope and the purpose of what is being assigned, and the author’s moral rights, for their part, cannot simply be signed away. Consequently, a sweeping “all rights, worldwide, in perpetuity” clause lifted from a foreign template may well achieve considerably less than the founder believes it does.

03 / THE TERM SHEET

# Price, terms and conversion

## 04

## Negotiating the headline instead of the terms

Founders tend to negotiate hard over the pre-money valuation while treating much of the remainder of the term sheet as boilerplate. Experienced investors, on the other hand, often do exactly the opposite, conceding on price and then quietly recovering the value elsewhere in the document.

In practice, three mechanisms do most of that work:

- **The option pool.** If a new pool is counted inside the pre-money valuation, its entire dilution falls on existing shareholders. A generous pool sized "for future hiring" can quietly lower the effective price by several percentage points.
- **The liquidation preference.** A 1x non-participating preference is the market norm. A participating preference, or a multiple above 1x, changes who is paid in a modest exit, which is the exit most companies actually have. Preferences also stack round after round.
- **Anti-dilution protection.** Broad-based weighted average is the usual position. A full ratchet can shift a striking share of the company to earlier investors after a single down round.

None of these terms is likely to appear in the press release announcing the round, and yet, taken together, they are what ultimately decide how much the founders take home.

## 05

## Stacking convertibles without checking they convert

SAFEs and convertible notes have become popular largely because they allow the valuation conversation to be postponed. That, however, is also where their danger lies, since each individual instrument is easy to sign, while their combined effect only becomes visible once they convert.

It is quite common for founders to layer several instruments on top of one another, each with a different cap and discount, and sometimes with most-favoured-nation clauses that reach back and reprice the earlier ones. Under the post-money SAFE that has now become standard in the United States, the dilution from every SAFE falls on the existing holders, which in practice means the founders, and yet relatively few founders actually run the conversion numbers before signing their third or fourth instrument.

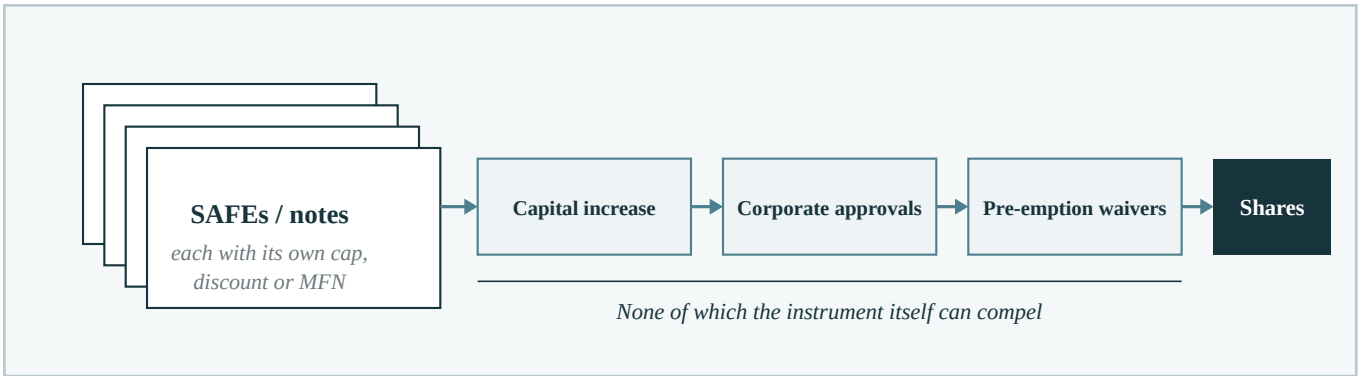



*Figure 4: What conversion requires when the issuer is a Jordanian company*

In this region, though, there is a more basic question to ask first, which is whether the instrument will convert at all. The standard SAFE was written for a Delaware corporation, and when it is issued by a Jordanian company, conversion requires a capital increase, the relevant corporate approvals and waivers of statutory pre-emption rights, none of which the instrument itself is able to compel. Under an LLC structure, conversion along the lines the SAFE contemplates becomes effectively out of the question. Either way, an investor who holds a right that cannot be cleanly delivered will almost certainly raise it at the least convenient moment.

04 / CONTROL

# Who makes the decisions

06

## Treating control terms as boilerplate

Whereas economic terms decide how the money is divided, control terms decide who makes the decisions along the way, including whether the company can raise further funds, be sold or change direction.

Investor vetoes, board composition, drag-along thresholds and information rights are often accepted as “standard,” and, taken individually, they may well be. When they are combined, however, and repeated across successive rounds, they can leave founders holding a majority of the shares and yet unable to take any significant decision on their own, at least where the company form allows those rights to be written into its constitution.

There are two points here that are routinely overlooked. The first is that the company form largely decides how much of this is real. In a Jordanian limited liability company, control broadly follows shareholding, since the Companies Law itself sets the voting majorities, with higher thresholds for structural changes, and leaves little room for vetoes or class rights. Investor protections therefore live only in the shareholders’ agreement,

where a breach will typically give rise to a claim but will not undo the resolution itself, and this is precisely why investors push for a private shareholding company or an offshore holding structure. The second point is that a board seat granted in the seed round quickly becomes the precedent that every later investor will expect to match.

05 / PROMISES & COMPLIANCE

# Informal promises and regulatory gaps

## 07

### Equity promised informally

*"We'll give you two percent once we raise."*

When this is said to an early engineer, an adviser or a friendly angel investor, the promise is rarely written down, but it is almost never forgotten by the person who heard it.

When the funding round eventually arrives, the investor's counsel will ask the founders to confirm that nobody else holds any right to shares in the company, and it is usually at that point that founders discover that a message, an email or a one-line offer letter may well be treated as a binding undertaking, with the percentage, the vesting and the price all left open to dispute.

Employee equity, moreover, brings its own local complexity. Jordanian law does not offer a ready-made framework for private-company option plans comparable to those available in the United States or the United Kingdom, and so such plans have to be assembled from general principles of company, contract, labour and tax law. A US-style plan transplanted without adaptation can therefore raise some awkward questions, particularly as regards employees' statutory entitlements and the way in which the benefit is taxed.

## 08

### Regulatory shortcuts that become price in due diligence

Due diligence is the point at which regulatory shortcuts acquire a price tag. An investor or acquirer who uncovers a gap will rarely walk away from the deal altogether; instead, they will usually reprice it, ask for a specific indemnity, or hold back part of the consideration until the issue has been fixed.

The gaps that we see most often in regional startups include:

- Personal data being processed without a clear lawful basis or a compliant mechanism for cross-border transfers, which matters all the more now that Jordan's Personal Data Protection Law is in force and Saudi Arabia, the UAE and others apply their own regimes;
- Fintech and payments activity being carried on without the appropriate central bank licence or sandbox status, often because the product gradually drifted into regulated territory after it was launched; and
- Expansion into Saudi Arabia or the UAE on a footing that does not match the licences the company actually holds.

In each case, the issue is far cheaper to resolve before a term sheet is signed than afterwards.

06 / CONCLUSION

# The common thread

None of the pitfalls described above is particularly exotic. What makes them expensive is that they are invisible at the moment they are created and only become obvious when they are discovered, which is usually by someone who, by then, holds the leverage.

**THE TAKEAWAY**

The founders who raise capital most smoothly are rarely the ones with the most elaborate documents, but the ones who asked the right questions early on.

In our experience, the founders who raise capital most smoothly are rarely the ones with the most elaborate documents; rather, they are the ones who asked the right questions early on, before signing the template, before promising the shares and before incorporating in the default structure.

***If you are preparing for a first institutional round, considering a holding-company restructuring, or would simply like to know which of these issues your company may already be carrying, our corporate and venture team would be glad to talk it through with you.***