


# Negotiating Term Sheets



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# What is a term sheet?

- aka- “Letter of Intent,” “Memorandum of Understanding,” “Agreement in Principle”
- Basic agreement on the material terms of the transaction
  - Road map, marching orders
- More detail is generally better (especially for the company)
- Legally binding? For the most part, no, but.....
- If you really want to mess up your transaction, this is the place to do it

# Non Binding

- A term sheet is not a binding agreement to fund
  - Subject to actual documents
  - Subject to due diligence
  - Subject to other closing conditions (legal opinion, etc.)
- Confidentiality
  - Term sheets typically have a binding confidentiality provision prohibiting disclosure of the terms and the existence of the term sheet
- Exclusivity
  - Term sheets typically give the investor some period of exclusivity (30 to 60 days)

# Types of Early Stage Financing Deals

- Seed Financing:
  - Convertible Notes
  - “Series Seed” or “Series AA” (i.e. Series A light)
- Series A
- Series B and later rounds

# What is a Convertible Note

- First and foremost, it is debt, so it sits above any equity (stock) in the capital stack
- However, it also has an equity feature in that it converts upon specified events into stock of the company
- The most common conversion is upon a “qualified financing” (generally an equity financing of a certain size), but notes can also provide for conversion on other events

# Key Features

- Conversion rate:
  - Fixed discount or increasing discount over time
  - Can have caps and collars (maximum and/or minimum conversion price)
  - If using caps, try to set a fixed price based on today's cap table
- Automatic conversion on qualified financing
  - e.g. upon an equity financing of \$1m
- Optional conversion (sometimes included)
  - By investor to common at cap price or other negotiated price
  - By company to common at floor price or other negotiated price upon maturity
- Interest
  - Converts along with principal
  - Interest rate is generally modest (for example, 5%), unless that is being used with a smaller discount

# Example

- \$100k convertible note, 5% interest, 25% discount upon qualified financing
- Company raises qualifying Series A at \$1.00 per share one year after issuing the note
- Note converts into shares of Series A:
  - Principal + interest = \$105k
  - Note converts at 25% discount, so at a price of \$0.75 per share
  - $\$105k / \$0.75 = 140,000$  shares of Series A (instead of 100,000 shares that a “new money” \$100k investment would purchase)



# Key Features (cont'd)

- Payment on acquisition:
  - Can be based on the discount, can convert at pre-determined price or can be a formula (e.g. 2x return)
- Maturity date
  - Later the better
  - Give yourself enough runway to get to the next milestone and have at least a 6 month cushion beyond that
- Collateral (secured or not)
- Amendment of notes
  - Use a single note purchase agreement that lets a majority of the principal amount of all notes amend the terms

# When to use Convertible Notes

- In most cases, will be simpler, faster and cheaper than doing a preferred stock financing, but not always
- Generally speaking
  - \$500k or less, use convertible notes
  - \$1m or more, use preferred stock (even if “seed preferred”)
  - But there are exceptions to both of these
- Consider your future financing needs:
  - If you may never need to raise more money, do a stock deal or build in an automatic (or optional) conversion of the notes at maturity
- Consider if you are able to value the stock:
  - Often convertible notes are a way to treat friends and family money fairly by deferring a valuation until “sophisticated investors” can negotiate with the company

# Company Pros and Cons

- Faster and cheaper to execute
- More control over your company (notes do not vote, and generally you don't give board seats or significant protective provisions to note holders)
- Delays dilution until you can increase the valuation
- Risk of getting to maturity date without resources to repay or a "plan B"
- Quickly "insolvent" on paper as the money is spent (although this helps with valuation position with respect to employee options and equity)

# Investor Pros and Cons

- Faster and cheaper to execute
- Discount can be small compared to the relative risk of the investment (misalignment of interests)
  - Valuation is too high in “homeruns” (can be mitigated by the use of caps)
- Having “debt” in an insolvent entity is not much protection
- Less control over the investment (delaying typical investor protections until conversion, but can negotiate for some, like pre-emptive rights or info rights)
- Capital gains treatment does not start until conversion happens

# Seed Preferred Alternative

- Increasingly, a number of “Series A Lite” or “Seed Preferred” deals are being done as an alternative to convertible notes
- Provides for equity without all of the usual bells and whistles of a full Series A deal
- Usually has at least a liquidation preference and pre-emptive rights, but may not have many more investor protections than that
- A few sets of standardized documents that are open source and available for use to keep transaction costs down:
  - Series Seed ([seriesseed.com](http://seriesseed.com))
  - YCombinator ([ycombinator.com/seriesaa.html](http://ycombinator.com/seriesaa.html))
  - TechStars ([techstars.com/docs](http://techstars.com/docs))

# Series A

- Takes the form of “Convertible Preferred Stock” with lots of contractual protections and benefits
  - “Preferred” - Preference over common stock on dividends, distributions, liquidation, redemption
  - “Convertible” - All of the upside of common stock

# Valuation

- Valuation is a constant source of confusion. SPELL OUT:
  - Pre-money
  - Fully Diluted – Elaborate if Necessary
  - Option Pool Impact
  - DO NOT BE CREATIVE. AT ALL. EVEN A LITTLE.

# Who Are Your Investors?

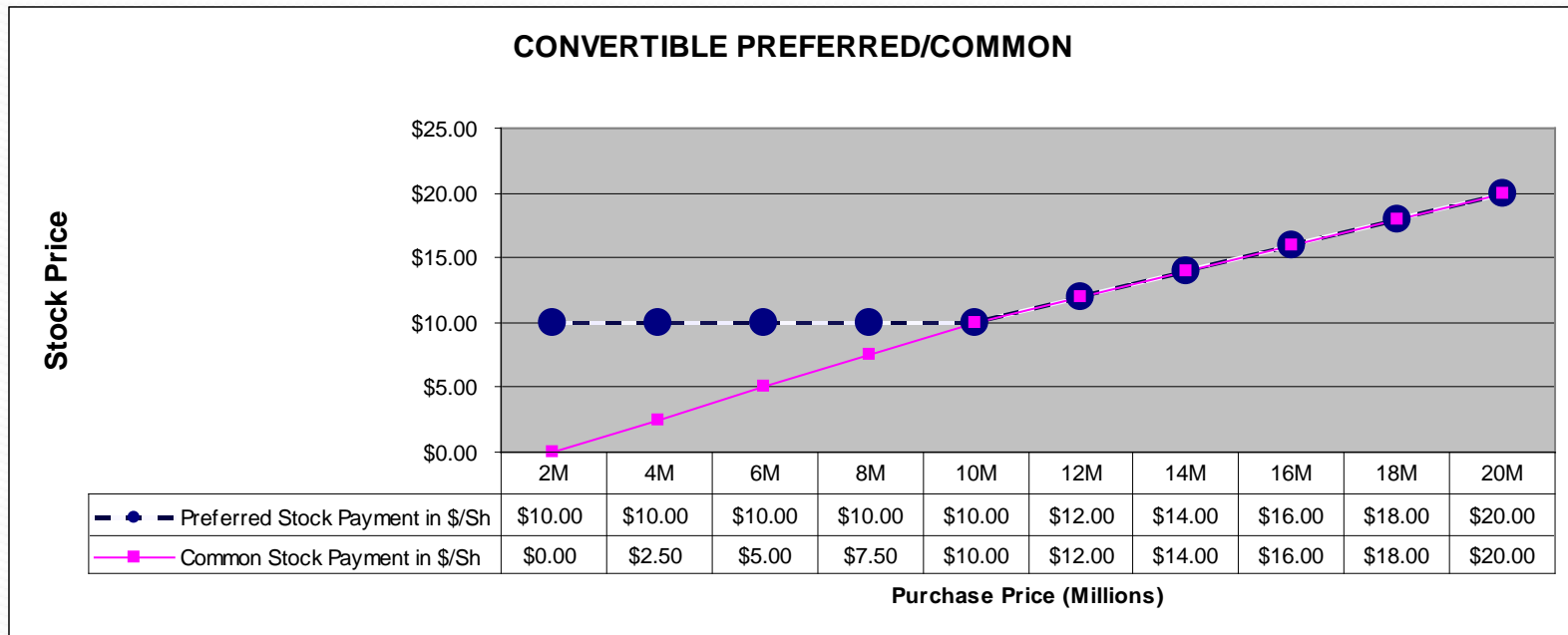
- Identify your investors, indicate who's committed and for how much.
- What gaps remain?



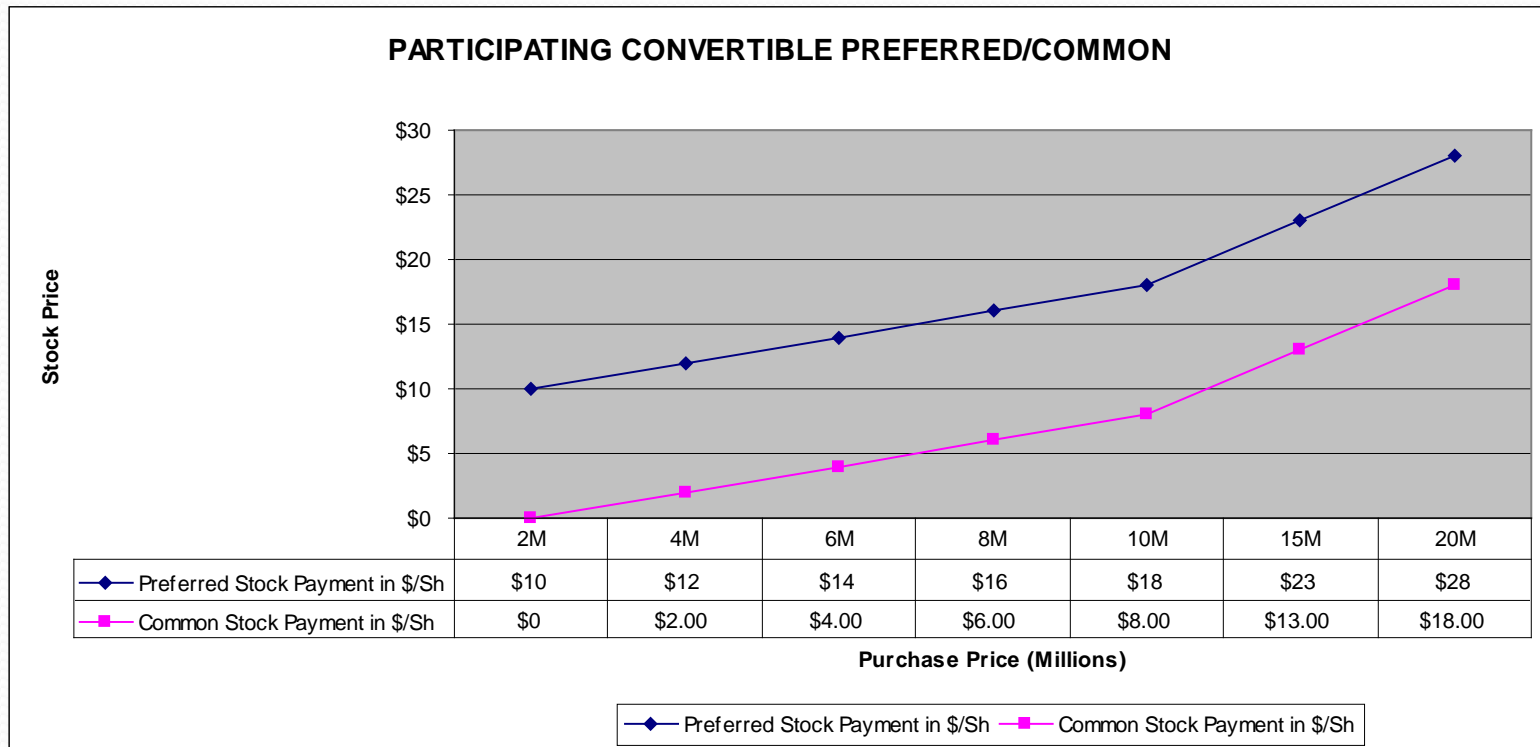
# Liquidation Preferences

- Non-Participating
- Participating
- Participating w/variations (caps, multiples)

# Non-Participating Preferred/Common



# Participating Preferred/Common



# Anti-dilution Protection

- Full Ratchet
- Weighted Average

# Anti-dilution Example

- ASSUME:
  - 1MM shares outstanding @\$5/share
  - Old Money = 100K shares (10% of the 1MM)
  - New Money purchases 100 shares @\$1/share

# Anti-dilution Example

- Weighted Average Anti-dilution:

- Old Money goes from 100,000 shares to 100,080 shares
- 10% to 10.006%

- Full Ratchet Anti-dilution:

- Old Money goes from 100,000 shares to 500,000 shares
- 10% to 35.712%

# Voting, Protective Provisions

- Consent of Preferred Needed to:
  - Reduce the Rights of Preferred Shares
  - Do another Financing

# Redemption Rights

- Present in most VC deals
- Almost never exercised
- Watch out for renegade investors



# Board Representation

- Balance of Board is always discussed
- Founders frequently give up control, even in a Series A round
- Outside Directors encouraged

# Pre-Emptive Rights

- Maintain percentage ownership
- Allocate ALL of next round to investors

# Registration Rights

- “The most heavily negotiated, and least important, part of any deal.”
- Language only a lawyer could love
- You’re at the Underwriter’s mercy anyway

# Right of First Refusal/Co-Sale

- Rarely contentious

# Tag/Drag Along Rights

- Simplify Exit
- Eliminate Appraisal Rights



# **Founder Vesting; Option Vesting**

# Caps on Transaction Costs

- Generally OK to cap the investor T/A costs paid by the Company
- Dangerous to cap Company T/A costs



# Information Rights





# No Shop Clause

# Pay-to-play Provisions

- Lose pre-emptive rights
- Lose anti-dilution protection
- Convert to Common Stock

# Final Thoughts

- Generate scarcity and interest:
  - best terms will come from competition
  - try to land multiple term sheets in a short window to increase your leverage and options
- Choose your investors wisely:
  - like a marriage, you will be with them for a long time
  - think about how it positions you for the next round, including issues like signaling and available dry powder
  - all money is not created equal
  - do reference checks on your investors with others they have funded

# Final Thoughts (cont'd)

- Choose your fights wisely:
  - make sure you know what really matters to you, and understand the market dynamics.
  - don't be afraid to ask “why do you need that?”
- Choose your legal advisors wisely. This stuff gets complicated fast. And do it early (before negotiating the term sheet!)

# Questions?

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