ANGEL CAPITAL ASSOCIATION

Deal Terms for Angels:
Tips and Strategies for Your Next Negotiation

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Contact Us:
Sarah Dickey, Membership Director
sdickey@angelcapitalassociation.org
913-894-4700x2

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It's All In The Terms - What To Prioritize In Angel Term Sheets

By: Marianne Hudson, ACA Executive Director and Angel Investor

An essential part of angel investing is setting and agreeing to the terms of the deal. Many angels recognize the importance of deal terms, but often wonder which components of the term sheet to prioritize. I'll reveal the answer, but first some background about term sheets.

A term sheet outlines everyone's intent for a deal. It is typically provided by the angel with help from their attorney. For this article I worked with angel investor Katherine O'Neill and attorneys, Ben Straughan, Partner, and Jim Carroll, Counsel, for the Perkins Coie Emerging Companies & Venture Capital practice. They also shared their insights in a recent Angel Capital Association webinar, The Key Points of Term Sheets.

A well written term sheet is critical because it leads to a great contract and creates investor-entrepreneur alignment needed for a positive relationship because it delivers the returns everyone wants, assuming the company is successful. O'Neill, executive director of Jumpstart New Jersey Angel Network, underscores this point: "This is the time you have the greatest opportunity to really control the main factors that allow you to make a good exit."

So what deal terms are most important to angel investors? Tapping their years of experience, Carroll and Straughan suggest five critical terms for a series seed preferred investment (otherwise known as a priced angel round):

Pricing: This represents the value of the company and helps determine how much of the company you will own. It is important to get the valuation of the company right in the beginning, which can be an art with startups and early-stage companies with few assets and short track records to build on.

Participation Rights: These define an angel's right to invest in future funding rounds, often providing the angel with a better chance of a good return. "Angels should focus on participation rights," Straughan said. "It allows you to double down by continuing your right to invest in future rounds."

Board and Information Rights: These rights outline whether you (or someone from the investing organization) will be on the board of directors or be an observer at company board meetings. They also determine the information you will receive from the company and how often you will receive it. For example by explicitly asking for quarterly financial statements and annual budgets, everyone can keep their eye on the ball on the status of the business while ensuring the company doesn't have onerous requirements (because these are documents that a company needs to produce anyway). Related to these, I like the idea of shareholders having the right to vote or at least have veto rights on key strategic issues such as selling or liquidating the company or developing entirely new lines of business.

Liquidation Preference: If the company is sold, these preferences define what preferred shareholders are paid e.g. X times the original purchase price before any other assets are paid common stockholders. 1X liquidation is normal for angels.

Redemption Rights: These rights can help angels to achieve liquidity by selling their shares back to the company if management wants to continue running the company but investors want out.

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Although these five components provide an excellent guideline for what to prioritize, term sheets can quickly get more complex, and most include many other terms which are also important.

Most experts recommend that angels start with a standard term sheet to help simplify the process and to reduce legal fees. I've provided sample term sheet examples in this article and there are a wealth of other online resources. These are a few of my favorites:

- Angel Resource Institute – Their term sheet resource center includes both example documents and helpful insights. They also offer workshops on understanding term sheets.
- FundingPost Venture Capital Glossary – This is a glossary of financial terms for angels and entrepreneurs to understand.
- Hyde Park Angels – How to Read a Term Sheet (and several other great blog posts)
- Investor IQ – The Kauffman Foundation, ACA and ARI provide a wealth of video and materials on all facets of angel investing from experienced investors
- Seraf Investor – Angel Fundamentals: Understanding Equity Deal Terms (Introduction), and many other great and important insights into being an angel investor

Term sheets are critical and that is exactly why they can sometimes be overwhelming. Beyond these resources I always recommend talking to other angels and learning about new approaches, trends and ideas at regional and national angel events. With resources like these there's no reason to sweat the terms on your own.

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Simple Term Sheets Align Angel Investors and Entrepreneurs for More Successful Deals

By: Marianne Hudson, ACA Executive Director and Angel Investor

Angel investor and entrepreneur relationships are similar to a marriage - both benefit when each relies on and supports the other. Wouldn't it make sense if this business marriage began with an agreement that supported both parties and focused on aligning goals instead of an adversarial "pre-nup?"

Things have been moving in this direction with term sheets designed specifically for angels and startups. Ten years ago angels typically used a standard term sheet developed for venture capitalists (VCs). The angel-specific term sheets are the next level of improvement.

Negotiating a term sheet is one of the most critical parts of the equity investment process; it defines the relationship between the investors and company. Done well, it leads to more detailed legal documents that close deals and get relationships and companies started out on the right foot.

In the last few years, a few experienced angels have asked how they can improve term sheets by reducing the number of terms and complicated legalese. Law firms have weighed in too.

Refreshed angel term sheets such as this are better aligning the needs and requirements of early stage investors and entrepreneurs. They simplify the common terms used in VC deals to fit the different requirements and situations of angels and true startups. For example, a VC term sheet averages 20 pages, compared to half that amount in an angel term sheet.

Case in point is one created by angel investor and former VC Dan Rosen. His nine-page Model Angel Term Sheet includes terms most relevant to angel investors and removes other terms that are not needed for the vast majority of deals funded by angels. The working document offers more than two dozen comments to explain the terms to all parties. Since the nature of angel deals can vary widely, the term sheet contains a wide enough variety of terms to match most deals while requiring limited negotiation.

A primary difference between angel and VC term sheets is that VC term sheets contemplate an IPO, which requires many more complicated terms. Most angel-backed deals focus on exits by acquisition.

Rosen, CEO of early-stage technology and consulting firm Dan Rosen & Associates and a former Board member of the Angel Capital Association, calls his angel term sheet "a 'plain vanilla', straight up the middle of the fairway, angel term sheet." It contains no unusual provisions, just the terms an angel needs to get a deal done. It balances being both entrepreneur and angel friendly.

Rosen's term sheet, often used in the Pacific Northwest, is catching on in other parts of the country. Key terms, some of which are also in VC documents, include:

Pricing: This is where most people start. It is important to get the valuation right at the beginning, as it helps determine what portion of the company you own and many other terms flow from it. Valuation is so critical that ACA is helping release InvestorIQ, a series of educational videos for angels. ACA's sister organization, the Angel Resource Institute, offers an in-depth course on Valuation of Early-Stage Companies, which is being offered at ACA's Leadership Workshop on September 18.

Board and Information Rights: Outlines the details for serving on Board of Directors or being an observer, as well as what information you receive from the company and how often. We know how important it is to returns that angels at least monitor financial performance to improve returns. I recommend this occurs at least quarterly.

- **Participation Rights:** This defines an angel's right to invest in future funding rounds. It helps maintain your pro-rata ownership as additional investors come in and to maximize your ownership if you choose to invest in the next round.
- **Liquidation Preference:** If the company is sold, this gives you - as a preferred shareholder - a payment of X times your original purchase price, paid out before any other assets are paid to holders of common stock. 1X liquidation is a norm for angels in this situation.
- **Redemption Rights:** This is more likely to be in an angel term sheet than in a VC one. Because angels are sometimes okay with smaller company growth for a decent return, it becomes an option for angels to get liquidity by selling the company if management wants to continue running the company but investors want out.

This standardized term sheet is catching on not only because it covers the things angels and startups need, but it cuts down on some of the more difficult things to negotiate, is easier for all parties to understand, takes less time, and reduces legal costs considerably. Lawyer jokes aside, saving these costs is a win-win for all, including the attorneys, who would like to see the company become successful and do the legal work when it becomes a larger company in the future.

Negotiating a term sheet for angel investors in the past would typically cost up to $40,000 in legal fees. Using a standard version costs $7,500 to $10,000, meaning more of the money goes to the company's growth rather than to legal fees.

If angels don't understand a term sheet, how can they expect entrepreneurs - those they are trying to partner with - to do the same thing? It's important to have standard documents that everyone understands to build strong relationships and increase the chances for mutual success. Angels understand that they have the best possible returns when entrepreneurs do well.

Angel term sheets make it so much easier for angels and entrepreneurs to start off their relationship aligned, rather than as adversaries. When all parties can work toward a common goal –there is a higher likelihood of success for the entrepreneur and good returns for the angels who back them.

Convertible Notes: Newfound Angel Flexibility?

By: Marianne Hudson, ACA Executive Director and Angel Investor

Angels are increasingly doing convertible debt deals. While not all angels are well-versed in this funding mechanism (or just plain don't like it), this deal structure is popular on the West Coast and catching on with entrepreneurs and angels who want more options for funding promising startup companies.

Angela Jackson, managing director of the Portland Seed Fund, has significant experience using convertible notes to fund startups. Approximately two-thirds of the fund's investments are in convertible notes, and she says they have produced better returns to date than priced seed rounds in the portfolio. She helped demystify this option for me and explained some newer twists that may make it more interesting to angels reluctant to invest in convertible notes instead of priced equity rounds.

First, some basics. A convertible note is a short-term loan that converts into equity when a startup raises their next round of funding, often in 12 to 18 months. The note defers the company's valuation to this next round of funding. Other provisions in most convertible notes include an interest rate (typically 8 percent to 10 percent) and maturity date, a cap on the valuation price for note holders when the loan converts to equity and a discount rate on the share price when the note converts. Many notes also include innovative terms that add more options for investors and align the interests of the entrepreneur and investors. More on those later.

Let's walk through these key provisions in a little more detail:

- **Discount rate:** establishes how much note holders are compensated for the additional risks they take for supporting very early-stage companies. If the note is executed with a 20 percent discount, the investor receives a higher return. Jackson offers this example: "If in the next round investors are paying $1 per share, the note converts at $.80 per share. On a $100,000 convertible note, the note buys the investor 125,000 shares, which is effectively a 25 percent premium. That is fair reward for coming in early."

- **Valuation cap or “Conversion cap”:** protects early investors from high valuations in the next fundraising round. With a conversion cap, the maximum valuation for the next round is set at a certain level, say $4 million or $5 million. This prevents investors from having their shares diluted if the next financing round is much higher, say $10 million or $20 million.

"In the past angels haven't liked convertible notes because without conversion provisions they were taking a lot of risk without the potential for reward," Jackson says. "As valuations get crazy, angels don't do as well if they put a little money into a $500,000 convertible note and the company does its next round at $20 million pre-money valuation. The angels' money won't convert into a favorable number of shares under those circumstances, yet they made it possible for the company to get there. An entrepreneur and angel friendly compromise is to set the conversion cap at around $4 million, which gives angels more security. Angels will own a lot more of the company even if it is valued in the next round at $20 million."

Provisions make convertible debt friendly to both entrepreneurs and investors. Investors receive a fair reward for coming in early to risky deals and these innovations offer terms with more options.

New market innovations in convertible notes add even more options and upsides for investors. One provision allows note holders to convert to equity if the company is acquired before the note converts. Investors use a 1X or 2X liquidation preference to get a return in this case. For example, if an angel invests $25,000 with a 2X liquidation preference, the return would be two times his or her money if the company is acquired early.

Another new innovative option is to convert to common instead of preferred stock once a company is acquired. This enables angels to stay with the company as it grows. Jackson says “I think entrepreneurs and investors at this early stage need a variety of options, because everybody who tells you they know what's going to happen is lying. With options you increase the range of scenarios under which both parties can prosper."

Building awareness of how innovations have revitalized convertible debt takes time. Some angels remain staunchly against it, and Jackson questions whether they're aware of the newer protective provisions used in notes. "Most people against convertible notes come from the old days," she says. "It's the difference between building a house with hand tools versus power tools. These conversion provisions that started over the past three years really changed the game for investors."

She offered a creative solution from a deal she recently viewed. The West Coast company was backed by investor groups from different US regions. They were raising on a $500,000 convertible note, but it had a provision that if $750,000 was raised, it would automatically convert into priced equity at a $3M pre-money valuation. “That incents the angels who don’t want to be in a note to corral other investors to get it over the threshold,” says Jackson who added, “more cash to execute, in a reasonable time frame, at a fair valuation and terms. What’s not to like?”

What kind of deals you do is really about personal style and how comfortable you are with a period of uncertainty about company valuation that comes with using convertible debt – and a few other important factors I will cover in part 2 of this article. I'm based in the middle of the country, which tends to be much more conservative than the coasts. I'm seeing fewer convertible debt deals than angels on the West Coast, but I have put money in a couple convertible note deals. My advice? Keep learning more and decide for yourself if convertible debt is right for you and the deals you're offered.

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Convertible Notes: The Debate Continues

By: Marianne Hudson, ACA Executive Director and Angel Investor

Convertible notes can add flexibility for many angels, as I wrote last week. I really like how Angela Jackson thinks about these deal terms for first investments in startups, but it also got me wondering: are angels still debating notes and priced rounds? I did a quick poll of angels, and boy did I get an earful. It's safe to say the debate is on!

Last week more than 100 members of the Angel Capital Association (ACA) responded to the survey. While not a scientific sample, it provides solid market representation since respondents were angels from across the US and Canada and invest in similar sectors and stages as the full ACA membership. Here's what I found out:

- 82% prefer to do priced rounds for their initial investments BUT
- 78% had done at least one convertible note in the last 18 months AND
- 25% had used convertible note for more than half of their first investment deals

Interestingly the preference for convertible notes has actually doubled since 2011, the last time I surveyed about deal term preferences. Clearly angels are drawn to certain convertible debt deals or companies, even if they don't love the deal terms. This feels like evolutionary change to me.

Another thing that surprised me: while I thought geographical location would correspond with preferences – e.g. Californians would most like convertible notes – this wasn't supported by the survey results. Midwesterners were just as likely to prefer convertible debt, for instance.

A few respondents didn't see convertible notes versus priced rounds as an either/ or decision. These angels viewed deal terms as a matter of what the deal looked like or how many investors were involved, and considered notes as "another tool" for investors. However, the larger majority strongly felt that it is an either/or choice.

So why is that? Here are the main reasons:

- **Missing investor-entrepreneur alignment** – Many angels use the term sheet negotiation process to make sure they're on the same page and to ensure that the final deal sets terms align entrepreneur-investor incentives. Said one respondent, "Unless the convertible has a low valuation cap, we are loaning CEOs money to achieve a valuation that we never would have agreed to in the first place. We are playing on opposite teams, where the CEO is using our money to achieve proof points to give us a crushing valuation (in the next round)."

- Another said that notes reduce the need for financial modeling and discipline, not only creating strange incentives, but setting the tone for disagreements to fester. Still others mentioned that they don't get to be on the Board of Directors with notes, further disconnecting the early investors and company.

- **Not wanting others to set the valuation** - There are up-round risks for all angel investments and perhaps even more with convertible notes. As one respondent said, "The valuation of my investment is now determined by others, whom I may not know and who may have bad judgment, later."

- **Next round investors didn't honor note terms** - Beyond others setting valuation there is another risk with next stage investors: at least two of the angels in the survey had the unpleasant experience of investors behind them not honoring the terms of the note. Each commented that they would have ended up with better terms in the A round had they started out with a priced round. Part of the issue is that their notes did not include investor protections that are normally included in an equity term sheet.

- **Missing out on tax benefits** – The US tax code includes a couple of important tax benefits for early stage investors, including one that allows you to monetize your losses and another the minimizes taxes on gains in qualified small businesses. The catch is that the "clock" for starting these benefits is when the investment is equity. When you invest in a convertible note the likelihood of missing out on monetizing big losses increases. Additionally, you have to wait until the next priced round –plus five years – to qualify for a 50 percent exclusion on taxes from a successful gain. There are also some tax liabilities on interest from loans to be aware of when notes convert to equity.

- **Bridge to nowhere** – Many convertible notes never convert to equity, if the entrepreneur isn't successful in securing a next round. This makes some angels say notes are "bridges to nowhere." Of course, investors can invest in companies using priced rounds that also aren't successful in securing a needed next round either. Some angels feel strongly that they will only invest in a convertible debt when it is a true "bridge loan" in which the next investors are known and their investment is in sight.

So where does this leave us? Clearly, the debate on early-stage investment terms continues. For some, priced rounds may be the right choice because of certainty in pricing, more investor protections, alignment, and tax treatments. Still others will prefer that convertible notes provide great flexibility, reduced legal costs, and simple terms for all. The right choice is yours to make and in my opinion, there is no one right answer. Pick what is right for you.

These posts originally appeared on Forbes.com

Marianne Hudson writes about angel investing – trends, ideas and how to succeed.

She is an angel investor and Executive Director of the Angel Capital Association (ACA), the world's leading professional association for angel investors. ACA is focused on fueling the success of accredited angel investors who support high-growth, early-stage ventures, and has more than 13,000 member angels across North America.