Beginner’s Guide to Term Sheets
March 23, 2016

Support by:

Founding Members:

Education Partners:
- Use chat to submit questions

- Yes, you’ll get the slides

- We’re recorded, so come back and listen again
- Mission: Fuel the success of angel groups and accredited individuals active in the early-stage landscape
- World’s largest trade group for angel investors
  - 220+ angel groups
  - 13,000 accredited investors
  - Voice of accredited individuals, portals, and family offices
- 50 US states + Canada
- Research/education partner

The Rising Tide Program
Member Groups

- Golden Seeds
- Life Science Angels
- Nashville Capital Network
- Launchpad Venture Group
- Tech Coast Angels
- TiE Angels
- Alliance of Angels
- New York Angels
- OHIO Tech Angels
- Common Angels
- New Dominion Angels
- Sierra Angels
- Houston Angel Network
- Sand Hill Angels

The Rising Tide Program
Member Groups & Accredited Platforms

Golden Seeds
Life Science Angels
Nashville Capital Network
FundersClub
Band of Angels
AngelList
Alliance of Angels
Launchpad Venture Group
Tech Coast Angels
TIE Angels
Common Angels
New York Angels
Sierra Angels
New Dominion Angels
Ohio Tech Angels
Houston Angel Network
Sand Hill Angels
ACA Partners

The Rising Tide Program
Rising Tide Education Program

Founding Members:

NEXT WAVE
Driving Diversity in Entrepreneurship and Angel Investing

portfolia

Education Partners:

ANGEL CAPITAL ASSOCIATION

GO BEYOND EARLY STAGE INVESTING

Support by:

KAUFFMAN
The Foundation of Entrepreneurship
OUR SPEAKERS

Arlene Bender
Partner
Foley Hoag

- Focuses on advising start-up and emerging growth companies regarding general business concerns including entity formation and equity structuring, contract matters and corporate governance
- Includes: angel and venture capital financing, private placements, debt financings and M&A
- Boston, MA
OUR SPEAKERS

Paul Silver
Shareholder
Karr Tuttle Campbell

- Focuses on commercial and real estate transactions, with an additional interest in health-care law
- Member of American Bar Association, the Washington State Bar Association, and the King County Bar Association ("Pro Bono Lawyer Of The Year – 1995)
- Former President of Evergreen Legal Services and Allied Art of Seattle, and Founding Director of Washington Volunteer Lawyers for the Arts
- Currently provides volunteer legal services to a nonprofit organization involved in "micro-lending" projects in Latin America, a nonprofit organization involved in health-care delivery projects in the developing world, and to residents of the Seattle Emergency Housing Shelter
- Seattle, WA
Topics We’ll Explore Today

- Term Sheet Basics
- Convertible Debt vs. Seed Equity
- Common vs. Preferred Stock
- Risk Mitigation
- Legal Structure
- Pitfalls to Avoid
Profile of The “Company”

- SaaS B2B software company focused on helping companies hire good employees faster & more efficiently by using potential employees network
- Company founded in spring 2015, currently self-funded
- 2 experienced co-founders
- Extended team includes 5 individuals; not taking any salary
- Mobile & web app
- Product in beta, plan for release in 60 days
- 3 pilot customers
- Large addressable market – US employers of 50+ people
Profile of The “Deal”

- Seeking $500,000 of convertible debt
- $25,000 minimum investment
- $100,000 already committed from well known angels
- Converts to equity upon raise of $1M
- 18 month term
- 5% interest, 25% discount upon qualified financing
- No cap
Some Questions from the Potential Investor

- How is seed financing defined?
- What are the implications of choosing convertible debt?
- What are the implications of common stock vs. preferred?
- Should I ask for a board seat?
- What are some of the risks I should be aware of?
Beginner’s Guide to Angel Investment
Term Sheets
What is a term sheet?

- An outline of the material terms of the transaction
- 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 usually have a binding confidentiality provision prohibiting disclosure of terms and existence of the term sheet
- Exclusivity
  - Term sheets may 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 is payable before any return on equity (stock) is distributed.
- However, it also has an equity feature in that it converts upon specified events into stock of the company.
- The most common conversion event is a “qualified financing” (generally an equity financing of a certain size), but notes can also provide for conversion in other instances such as sale of the company.
- Bears interest at a modest rate, which will convert into equity along with the principal.
Key Features

- **Conversion rate:**
  - Usually has a fixed discount or increasing discount over time on the conversion price set by a qualified financing
  - May have a cap (maximum conversion price regardless of valuation in the qualified financing)
  - 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
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.)

- 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
  - Should be based on giving company 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 whether parties can agree on Company’s value:
  - Often convertible notes are a way to treat angel money fairly by deferring a valuation until “sophisticated investors” can negotiate with the company
  - Often the company and the investors just can’t agree on the value of the company at an early stage
Company Pros and Cons

- **Pros:**
  - Faster and cheaper to execute
  - Leaves more control over company with founder (noteholders do not vote, and usually don’t obtain board seat rights or significant protective provisions)
  - Delays dilution until company can increase its valuation

- **Cons:**
  - Risk of getting to maturity date without resources to repay or a “plan B”
  - Quickly “insolvent” on paper as the money is spent
Investor Pros and Cons

Pros:
- Faster and cheaper to execute

Cons:
- Discount can be small compared to relative risks of the investment (misalignment of interests); valuation can be too high in “homeruns” (can be mitigated by use of cap)
- 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.
Series A Preferred

- Takes the form of “Convertible Preferred Stock” with rights prescribed in company’s charter, as well as contractual protections and benefits

- Why Convertible Preferred Stock?
  - “Stock” – equity ownership (junior to debt)
  - “Common Stock” – basic unit of equity ownership; issued to founders/employees/consultants.
  - “Preferred” - Preference over common stock on dividends, distributions, liquidation, redemption
  - “Convertible” – Convertible into common stock, with all the upside of common stock
Convertible Preferred Stock

- Charter terms:
  - Liquidation preference
  - Dividend rights
  - Conversion rights including antidilution adjustment rights
  - Veto rights

- Contractual control/protection issues:
  - Voting control and board seats
  - Veto rights
  - Equity participation rights
  - Drag-along rights
  - Registration rights
Protective Provisions

- AKA “Negative covenants,” “Veto rights” or “blocking rights”
- Essentially a list of things company can’t do without investors’ prior consent
  - Consent at either the Board or Stockholder level
- Usually hotly negotiated
- This is a foot on the brake, not on the accelerator
- Gets complicated in later rounds; interests of investors can diverge
- The relevant thresholds are very important depending on the dynamics of company’s investor base
Additional Resources

www.startuplawblog.com/2012/06/02/convertible-debt/


http://www.forbes.com/sites/mariannehudson/2015/08/12/convertible-notes-the-debate-continues/#7ec9860b77ba

http://www.forbes.com/sites/mariannehudson/2015/07/30/convertible-notes-part-1-newfound-angel-flexibility/#1a69f616a70f
Speakers Contact Information

- Arlene Bender: abender@foleyhoag.com, (617) 832-1102

- Paul Silver: psilver@karrtuttle.com, (206) 224-8062
Thank you!

Upcoming Webinars

April 13, 2016: Investor Strategies from Experienced Angels

April 27, 2016: How to Source the Best Deals - Outside Silicon Valley

Webinar programs archived at: [www.angelcapitalassociation.org/events/webinars/](http://www.angelcapitalassociation.org/events/webinars/)
Additional Resources

Marianne Hudson
Executive Director
Angel Capital Association

http://www.angelcapitalassociation.org/news-forbes/

Christopher Mirabile
Managing Director, Launchpad;
Board Chair, Angel Capital Association

http://www.angelcapitalassociation.org/news-inc/

The Rising Tide Program
Upcoming ACA Events

- April 5, 2016: New England Regional, Boston, MA
- May 9 – 11, 2016: ACA Summit, Philadelphia, PA
- September 22, 2016: Best of the Midwest Regional, Minneapolis, MN
- [http://www.angelcapitalassociation.org/events/](http://www.angelcapitalassociation.org/events/)