

Basic Deal Structures

February 24, 2021



ANGEL CAPITAL ASSOCIATION



Angel Capital Association Today



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- Use chat to submit questions
- Yes, you'll get the slides and video
- We're recording, so come back and listen again
- Contact Heather Krejci with questions:
hkrejci@angelcapitalassociation.org

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SPEAKER



Kevin Learned
Loon Creek Capital
Sage Growth Capital



Kevin Learned

- Exited Entrepreneur in software
- Angel investor since 1995
- 60+ deals (personal plus funds he created)
- Co-Founder Boise Angel Alliance
- Co-Founder Venture College at Boise State University
- Partner
 - Loon Creek Capital Group (SPV and Fund administration)
 - Sage Growth Capital Funds (revenue-based capital)
- Board of Directors, Angel Capital Association
 - Chair Education Committee
 - Lead Instructor, Term Sheet Basics



WITH GRATITUDE TO

- Dr. Ron Weissman, Angel Capital Association Board member and Vice Chair, Education Committee
- Christopher Mirabile, Hambleton Lord and Seraf, Educational Partner
 - Term Sheets and Valuations

Seraf published a series of article on equity deal terms at:

<https://seraf-investor.com/compass/article/angel-fundamentals-understanding-equity-deal-terms-series>



ANGEL UNIVERSITY (SMART PRACTICES) *italics in development for 2nd half 2021*

- **Angel Investing Basics**

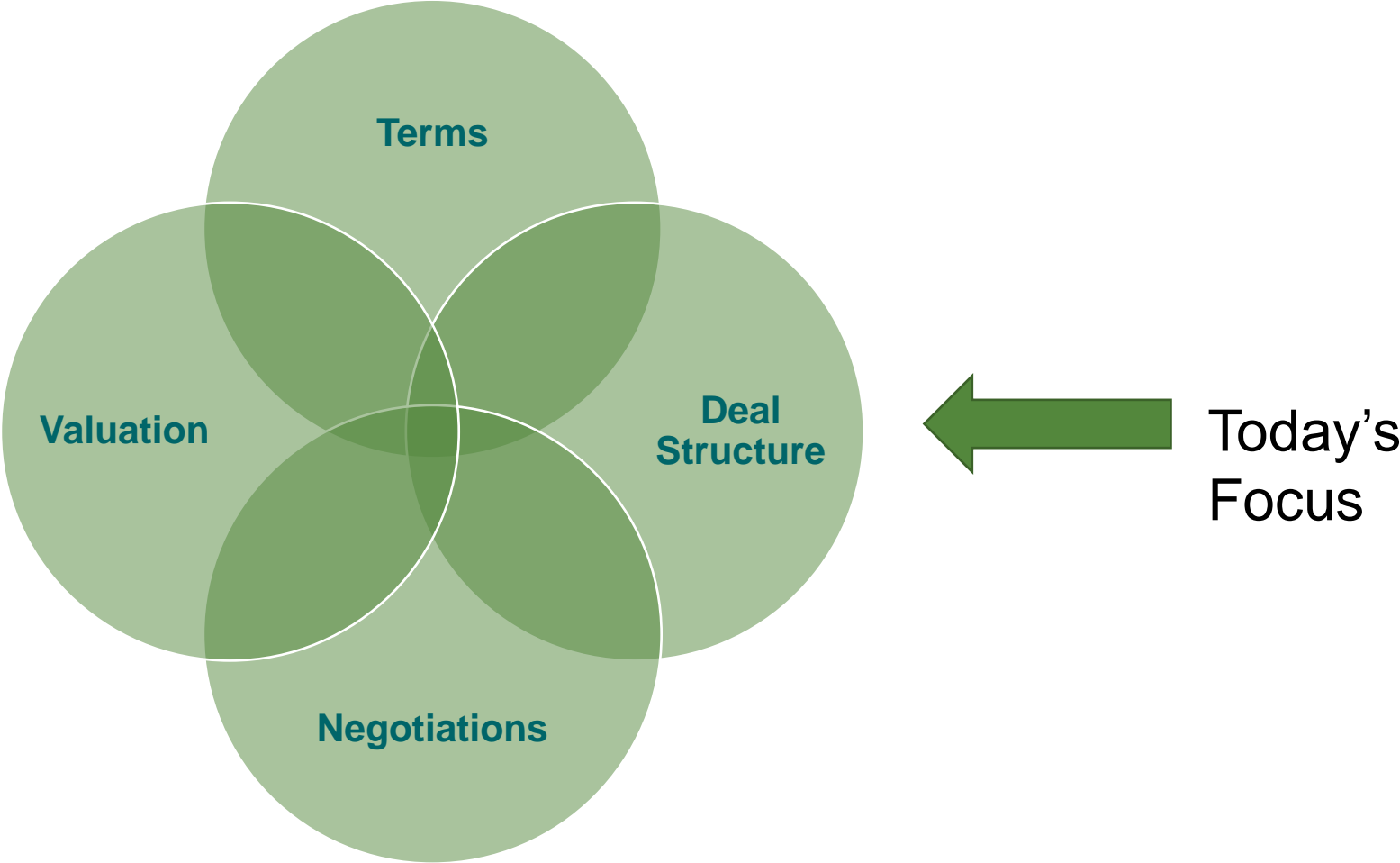
- Fundamentals of Angel Investing
- Term Sheet Basics
- Due Diligence Workshop
- Valuation Workshop
- Returns and Portfolio Strategy
- *Convertible Note Basics*
- *Evaluating Risk*

- **Deeper Dive**

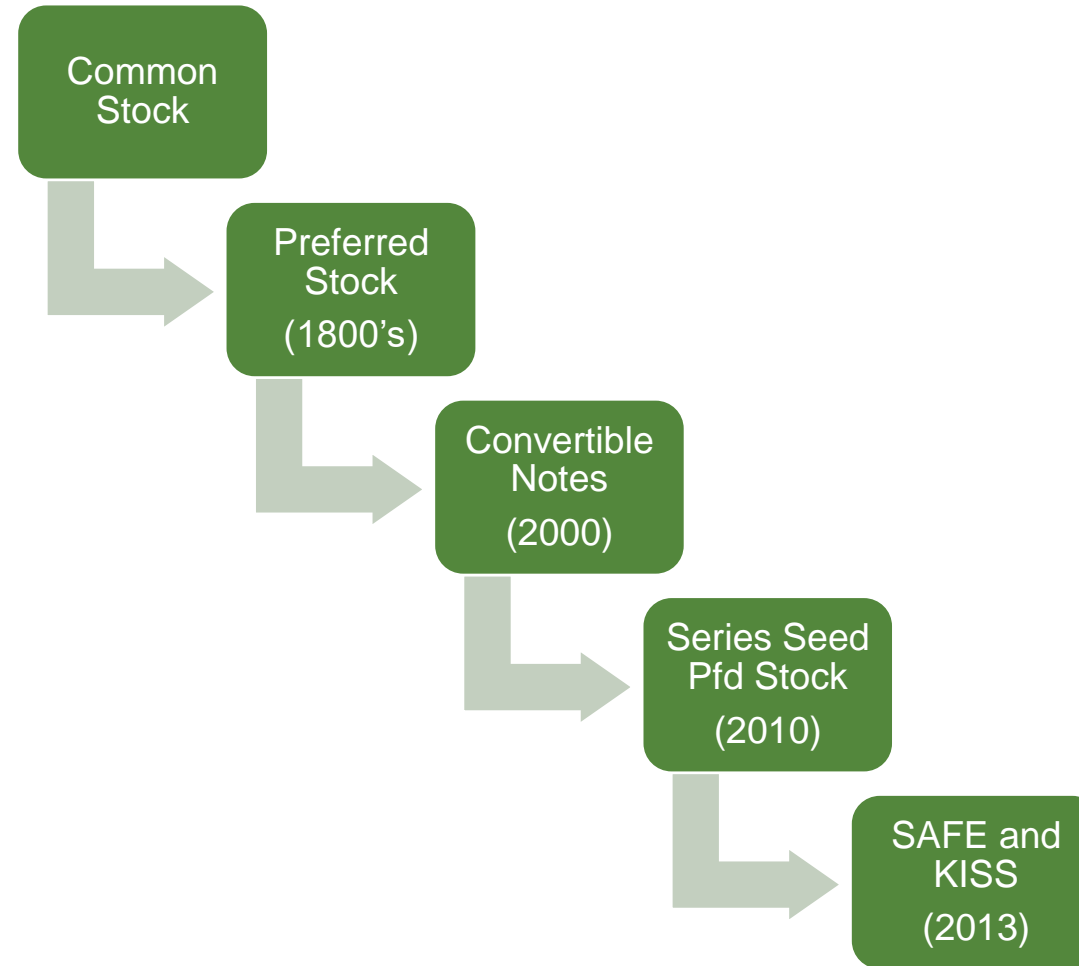
- Advanced Capitalization Tables
- Startup Boards
- *Exit Strategies*



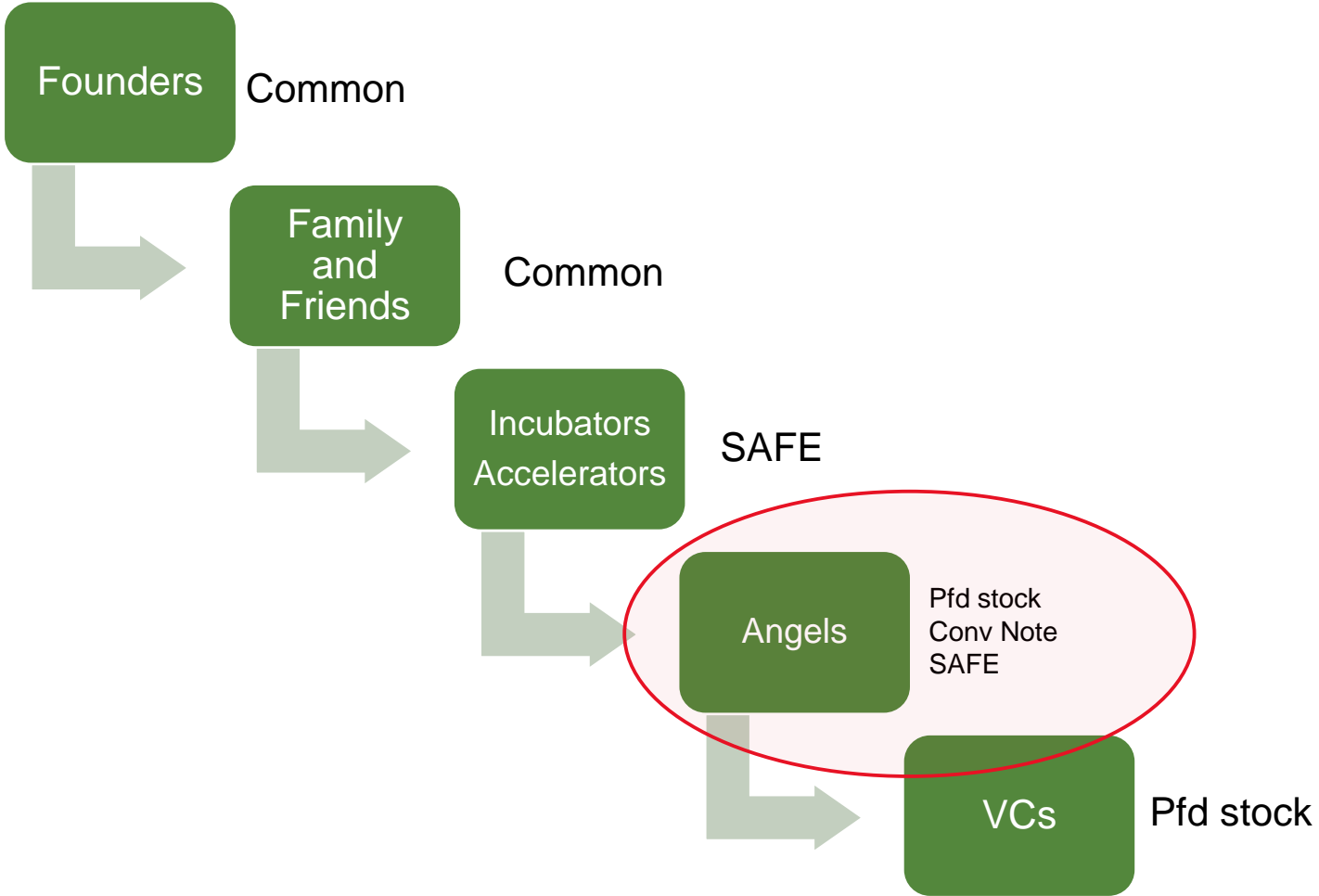
ASPECTS OF A DEAL



EVOLUTION OF CAPITAL STRUCTURES



TYPICAL FUNDING PATH



TYPICAL ANGEL SECURITIES

- “Priced Equity” or Stock (**owner**)
 - Common
 - Preferred
 - Series Seed
 - National Venture Capital Association (NVCA)
- Convertible Debt (**lender**)
- Derivatives (**speculator**)
 - SAFEs, KISSes



2019 ACA MEMBERS INVESTED

- 52%--preferred stock
- 39%--convertible notes
- 6%--common stock
- 3%--SAFEs

Source: [Angel Capital Association 2019 Angel Funders Report](#)



CRITERIA FOR EVALUATING DEAL STRUCTURES



Deal Economics

- Size of round
- Pre-money valuation
- Liquidation preference
- Option pool
- Dividends



Management & Control

- Board seats & control
- Information rights
- Founder vesting, IP assignment, non-compete and more



Investor Rights & Protection

- Approval rights
- Participation rights
- Anti-dilution
- ROFR & co-sale rights















Exits & Liquidity

- Rights to block founder transfers
- Drag-along rights
- Redemption rights
- Registration rights



ANGEL SECURITIES SUMMARY

Rights	SAFE	Convertible Note	Series Seed Pfd Stock	NVCA Pfd Stock
<i>Clear deal economics</i>	 Post-money with cap	 With cap		
<i>Management and control (governance)</i>				
<i>Investor rights & protections</i>				
<i>Exits & liquidity control provisions</i>				
<i>Cost</i>				
<i>Negotiation/complexity</i>		*	**	****



SAFE

Entrepreneur: We need money right now. Please sign this one pager proving that you did give us money. After this initial early funding craziness is over, we'll figure out what equity you own. Let's not obsess about it now. Deal?

SIMPLE CONTRACT EXCHANGING FUNDING NOW FOR NOW FOR POSSIBLE EVENTUAL CONVERSION TO EQUITY AT FUTURE TRIGGERING EVENT



SAFE

- **What is it?**

- A **simple** contract
- Provides for **possible** conversion upon a triggering event
- May convert pre-money (bad) or post-money (not as bad)
- May or may not be capped or provide a discount.
- Fast/cheap and doesn't require lawyers

- **What isn't it?**

- A note or debt
- Stock
- May not be a guarantee of conversion (read carefully)



CAPPED POST- MONEY SAFE



Deal Economics

- Size of round
- Pre-money valuation (capped valuation)
- Liquidation preference
- Option pool
- Dividends



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CAUTIONS REGARDING SAFES

- https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_safes
- <https://www.finra.org/investors/insights/safe-securities>



SMART PRACTICES-SAFES

SAFEs are one-sided contracts which generally angels should avoid.

SAFEs come in

- Pre-money version (original SAFE). In a pre-money SAFE the holder does not know the economics until the conversion event, and every SAFE converted is dilutive to your SAFE.
- Post-money SAFE with a cap. In this version, if there is a conversion event, you know the economics when you buy the SAFE

If you are going to invest in a SAFE, only invest in a post-money SAFE with a cap

For a thoughtful discussion of pre and post money SAFEs, see <https://cytlaw.medium.com/post-money-safe-math-problems-3f9afca5be61>



CONVERTIBLE NOTE

Entrepreneur: We need money right now. And lets not get hung up over valuation or spend a lot of money we don't have on attorneys. When we sell stock, we'll give you a discount. Deal?

DEBT FINANCING WITH MATURITY DATE, INTEREST, CONVERSION MECHANICS



CONVERTIBLE NOTE

What is it?

- A promissory note with interest and a due date
- Provides for conversion or cash upon a triggering event or due date
- Converts at lower of a discount or a valuation cap
- Generally favorable to entrepreneur/company

What isn't it?

- Stock (ownership)
- Protection beyond that of unsecured debt



CAPPED CONVERTIBLE NOTE ILLUSTRATION (TRIGGERING ROUND AT \$20 MILLION PRE-MONEY)

- **20% discount, no cap**
- Triggering round pre-money \$20,000,000
- Discount 20%
- Note converts at \$16,000,000
- Pre-money \$20,000,000
- Discount \$4,000,000
- Conversion price \$16,000,000
- **Lesser of 20% discount or \$10 million pre**
- Conversion price at discount: \$16,000,000
- Cap: \$10,000,000
- Therefore, convert at \$10,000,000 pre-money (an improvement of 37.5%!)

For details on convertible debt instruments, see article by Seraf at:

<https://seraf-investor.com/compass/article/guide-angel-investing-documents-convertible-debt-deals>



CAPPED CONVERTIBLE NOTE



Deal Economics

- ~~Size of round~~
- ~~Pre-money valuation (with cap)~~
- ~~Liquidation preference~~
- ~~Option pool~~
- ~~Dividends Interest~~
- **Debt**



Management & Control

- ~~Board seats & control~~
- ~~Information rights~~
- ~~Founder vesting, IP assignment, non-compete and more~~



Investor Rights & Protection

- ~~Approval rights~~
- ~~Participation rights~~
- ~~Anti-dilution~~
- ~~ROFR & co-sale rights~~



Exits & Liquidity

- ~~Rights to block founder transfers~~
- ~~Drag-along rights~~
- ~~Redemption rights~~
- ~~Registration rights~~



SMART PRACTICES: CONVERTIBLE NOTES

Recognize you have little protection with a convertible note. If you invest anyway be sure:

- You see a clear path to the priced round in a reasonable period
- You negotiate a reasonable maximum valuation at conversion (a “cap”)
- At conversion, the interest accrued will be taxable income, plan accordingly



PRICED EQUITY

Investor: I am willing to invest assuming there is a reasonable valuation and I receive preferences and protections. Yes, this will take a while, will constrain you (the entrepreneur), and will incur significant costs . Deal?

(PREFERRED STOCK)

OWNERSHIP WITH SPECIFIED VALUATION, CLEAR POST-MONEY CAPITAL STRUCTURE AND COMPREHENSIVE INVESTOR RIGHTS AND PROTECTIONS



WHAT IS PREFERRED STOCK

- Percentage ownership of company
- Purchased at an agreed upon price
- Includes some “preferences” senior to common stock



PREFERRED STOCK



Deal Economics

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- Pre-money valuation
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Investor Rights & Protection

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Exits & Liquidity

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SMART PRACTICES, PREFERRED STOCK

- A well-structured priced preferred round is the gold standard of angel investment structures.
- However, a fully featured round will be expensive and likely require significant negotiations with counsel for both sides.



SERIES SEED

Investor: I am willing to invest if there is a reasonable valuation and I receive basic preferences and protections, assuming I can have the rights of the next round when it occurs. Deal?

SIMPLIFIED PREFERRED EQUITY WITH BASIC GOVERNANCE AND INVESTOR RIGHTS, INHERITS NEXT ROUND PREFERRED RIGHTS

Series Seed Term Sheet: www.seriesseed.com



SERIES SEED PREFERRED STOCK



Deal Economics

- Size of round
- Pre-money valuation
- Liquidation preference
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Management & Control

- Board seats & control
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Investor Rights & Protection

- Approval rights
- Participation rights
- Anti-dilution
- ROFR & co-sale rights
- Inherits rights of next round



Exits & Liquidity

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SMART PRACTICES – SERIES SEED

Series Seed documents are a compromise between

- few protections with a convertible note
- the full protections of an NVCA term sheet.

There are few items to negotiate, and legal costs will be minimized.

I have posted a memo I wrote on the use of Series Seed stock for the Boise Angels to our website: www.looncreekcapital.com. Click on Resources and then on Tools.



A NOTE ON TAXES

- IRS Section 1202: 100% exclusion from capital gains taxes for “Qualified Small Business Stock” (QSBS) held for more than 5 years up to the greater of 10X investment or \$10,000,000
- IRS Section 1244: Up to \$50,000 (\$100,000 for joint return) of a loss on QSBS stock is deductible against ordinary income.

Note: only investments in stock qualify and holding period begins at date of purchase of stock, or date of conversion of SAFE or convertible note.



LEARNED'S PHILOSOPHY OF EARLY-STAGE TERMS

- One of two things will happen:
 - The company will fail, and I will lose all my investment (regardless of instrument).
 - The company will require more money which will be provided by investors richer and smarter than I am.
- How do I protect myself against these eventualities? Series Seed
 - Insures good governance and good information
 - Keeps basic blocking and participation rights
 - Gives me rights of next round



Questions



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ANGEL CAPITAL ASSOCIATION

Upcoming Events

- Startup Boards Workshop - **March 2**
- 2021 ACA Summit – **May 4-6**



Angel Capital Association Angel University

- ACA Angel University Basics – **March 8 – March 11**
- ACA Angel University **at the 2021 Summit**
- Learn More

<https://www.angelcapitalassociation.org/aca-angel-university/>

