



# The Rising Tide Program

## Beginner's Guide to Term Sheets

March 23, 2016

Support by:

**KAUFFMAN**  
The Foundation of Entrepreneurship

Founding Members:

**NEXT WAVE**  
Driving Diversity in Entrepreneurship  
and Angel Investing

**portfolia**

Education Partners:

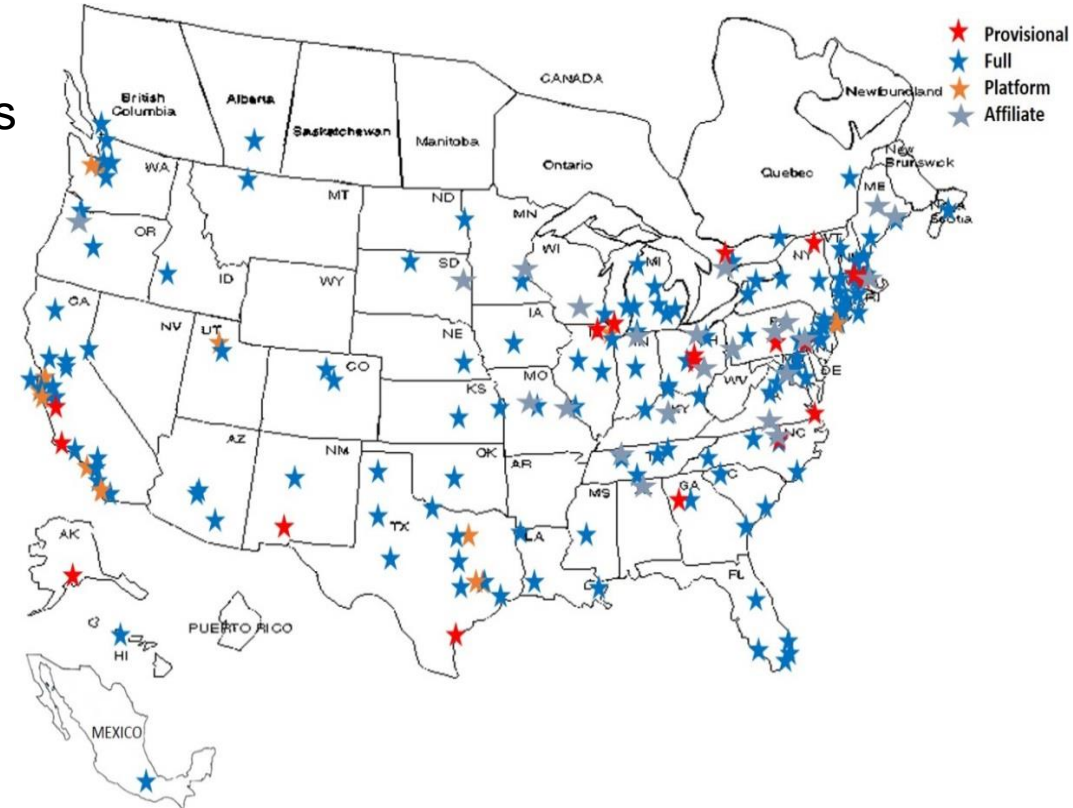
**ACA**  
ANGEL CAPITAL ASSOCIATION

**GO BEYOND**  
EARLY STAGE  
INVESTING



- 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 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



# Member Groups



LIFE SCIENCE ANGELS



The Rising Tide Program

# Member Groups & Accredited Platforms



LIFE SCIENCE ANGELS



FundersClub



New Dominion Angels



Houston Angel Network



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# ACA Partners



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# Rising Tide Education Program

## Founding Members:



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## Education Partners:



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## Support by:



# 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

- 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)

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



- 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

- **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

- \$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)

- 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

- 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

## ■ 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

## ■ 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

- 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



- 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

- 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

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

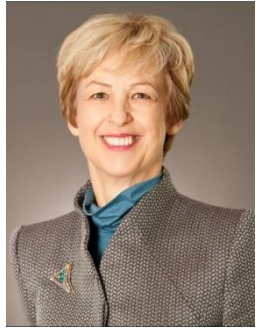
<http://www.forbes.com/sites/mariannehudson/2015/12/11/its-all-in-the-terms-what-to-prioritize-in-angel-term-sheets/#78a85d1a4a72>

<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](mailto:abender@foleyhoag.com), (617) 832-1102



- Paul Silver: [psilver@karrtuttle.com](mailto: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/ev  
ents/webinars/](http://www.angelcapitalassociation.org/events/webinars/)



# Additional Resources



**Forbes**

Marianne Hudson  
Executive Director  
Angel Capital Association



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



**Inc.**  
Handbook of the American Entrepreneur

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



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

# 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/>



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