QuickLaunch University Webinar Series Transcript
Term Sheet Basics and Negotiation Tips

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Presented by WilmerHale Partner Joe Wyatt and Counsel Jenna Ventorino

Joe: Hello, everyone, and welcome to today's QuickLaunch University Webinar. My name is Joe Wyatt. I'm a Partner in WilmerHale's Corporate Practice in Palo Alto. I'm joined by my colleague, Jenna Ventorino, who is counsel in the firm's Corporate Practice based in Boston. Over the last year, we've explored many different legal issues faced by entrepreneurs and early-stage companies as they begin to build their businesses.

If you're interested in listening to our previous sessions, links to the on-demand recordings are posted to our website at wilmerhalelaunch.com.
The first item that we wanted to go over is a high-level overview of the various investment instruments that are used for early-stage or C-stage companies, the first of which is a SAFE, which is a Simple Agreement for Future Equity. I'm sure many of you are familiar with this. It's basically an agreement to buy equity in a future financing.

The positives or pros to this investment tool: it's simple, it avoids the need to determine a specific valuation and it is relatively inexpensive. It's usually not negotiated or only has very minor changes to the document and it doesn't require you to have a liquidation preference overhang in connection with the financing.

The second one is a convertible note. Convertible notes were pretty popular for C-stage financings probably a couple of years ago, maybe three years ago. They've been largely replaced by SAFEs, but they are still used by some investors who want to have a debt position as opposed to an equity position in the company.

The positives about convertible notes are, again, they're relatively inexpensive to put in place. They also postpone valuation discussions and the investor receives the protection of debt prior to its conversion. The cons are they put some investment pressure on the company, meaning that they generally have a maturity date which requires the company to complete a financing prior to the maturity day. They are also debt instruments, so they receive any type of return prior to the holders of equity, including the founders who own common stock. And lastly, there may be some potential tax exposure for the discount on conversion.

Last is a kind of standard Series C stock financing. This type of financing requires you to set the valuation, set definitive rights of the investors, and also provide current voting rights for the investors. The cons to this type of financing are that it's somewhat complicated as compared to a SAFE or convertible note financing. It's more expensive compared to a SAFE or convertible note financing. And as we'll get into a little bit more later, it provides more control for the investors as compared to a SAFE or convertible note financing.

Next, we'll move on to the term sheet and will talk about the basics. A term sheet first summarizes the particular terms of the transaction. It should be noted that it's non-binding with certain exceptions,

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usually confidentiality and exclusivity. It focuses on the key aspects or issues in the financing. It's generally prepared by the investors. Once the investor submits the term sheet, usually the company will comment on it. There will be a little bit of back and forth and then the term sheet is finalized.

Many companies use the NVCA form term sheet because it's somewhat of a standard form. It's pretty detailed as compared to other types of term sheets that are often provided by investors and it includes a kind of customary provision, so it cuts down on the amount of negotiation that is required to finalize the term sheet. Now, I'll turn it over to Jenna, who will talk about some concerns in VC transactions.

Jenna: The principal concerns in VC transactions often have to do with the influence that the investors can exert over the company once the transaction is closed. There are a number of different ways that the investors can exert their control. They often negotiate for themselves and take rights over certain corporate actions.

They require certain positive and negative components from the company, such that the company would promise not to do certain things without investor sign off or promise to do certain things at all times while the investors have their money invested in the company. Investors often have control or very large influence over exit events and liquidity events for the founders.

And other things to think about are the ownership percentages and dilution, which are often something that the investors are quite concerned about, and then, on the other hand, that the founders are quite concerned about. On the investor side, they're trying to protect their investment and the cash that they've deposited into the company, and on the other hand, the founders are trying to maintain their percentage of the company and as much control as possible.

And then there's also incentives for management employees. Beyond the initial founders of the company, those folks who are there on a day-to-day basis and running the company, how you keep them motivated and incentivized to drive the company forward.

The next couple of slides have to do with some basic vocabulary and calculation with respect to term sheets. The big phrases that people often use when talking about term sheets is the pre-money valuation and that's the value of the company prior to the investment coming in. The post-money valuation, on the other hand, is the value of the company after the investment. Therefore, the pre-money valuation plus the investment is the post-money valuation.

And then you often hear the term fully diluted shares and I'm going to explain why on the next slide. But fully diluted shares is a term that's often misunderstood and the way that it should be thought of, generally speaking, is that we assume that all of the shares that could be issued are issued. So, for this purpose, we're counting all of the outstanding equity securities, so all of the common and preferred stocks, plus any outstanding warrants, plus any outstanding options, and usually, plus the option pool even if the option pool is unallocated.

If you have, for example, a 10% unallocated option pool, then that's being counted in your fully diluted share number. And the reason why all of this matters is because those numbers are what drives the price of the company. The pre-money valuation, the higher the pre-money valuation, the lower the percentage of the company the investors will be able to buy with a set dollar amount.

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And to determine the price of the shares that will be sold in a financing, you will divide the pre-money valuations by the fully diluted share number, which is why understanding what the investor means by fully diluted shares is so important. The result of that calculation is the price per share for the new financing.

Joe: So now we're going to talk a little bit about the different terms or provisions for a preferred stock financing, the first of which are dividends, and that's a specific rate of return on the investment. I'll say from the outset that dividends are very rarely declared by a startup company because they're not going to use the capital that they raised to turn around and make distributions to the stockholders. They're going to use the capital that they've raised for the company's operations. But it is important to just know because it is one of the key terms of a preferred stock financing.

Dividends can be cumulative or non-cumulative. The Certificate of Incorporation will dictate how the dividends will be declared if at all. The preferred dividends will usually be expressed as a dollar amount. Cumulative dividends, meaning dividends that accrue over time, whether or not they become payable, are somewhat uncommon, but sometimes you do see those.

Non-cumulative dividends, if and when declared by the board, is usually the common structure for dividends because you'll have a stated dividend, but they'll only be declared by the board, and usually, the board will not declare them because, as I said earlier, startup companies generally do not declare dividends because they want to retain the capital for their operations.

Jenna: Liquidation preference is something that is often talked about in financing and it's important to understand. Liquidation preference provides a specific return for the investors, for the holders of preferred stocks, and they get this return in preference to other equity holders. Often, that amount is the invested dollars in, plus any accrued and unpaid dividends, which is why Joe's slide was so important.

This is traditionally thought of as downside protection where the price on exit is lower than would be ideal. But there are significant upsides to liquidation preferences and we see that when we have something called participating preferred stocks. Participating preferred is where the investor gets their dollars and their dividends, plus then, they get to participate with the common stock as though they...and in as converted to common stock basis.

They get a big chunk of the liquidation price at the outset of the transaction in preference to everybody else and then they participate with the common stocks so they get whatever percentage they have in the company. On a pre-diluted a basis, they get to participate in the remainder of whatever's left over. So, you can see how that would be particularly problematic in a situation where the company wasn't getting a huge valuation at an exit event.

One of the ways that you can limit this as you're negotiating your term sheet is you can try to resist participating preferred at all. And if that's not an option, you can try to limit it with a specific multiple or IRR hurdle that would allow the investors and the preferred stockholders to get back a certain fixed dollar amount after which they would relinquish this right—so the remainder of the liquidation consideration would go exclusively to the common stockholders.

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Joe: An additional term or provision for a preferred stock financing are the covenants and these are often referred to as protective provisions. There are certain things that the company is required to do or affirmative covenants, and those are things like delivering financial information, providing access to management and corporate records, maintaining, you know, board meetings and frequency of board meetings, delivering budgets, those types of things. Usually, those aren't difficult at all to comply with.

The second type of covenants are negative covenants and these are the protective provisions generally. And as Jenna alluded to earlier, whenever we do a preferred stock financing, we kind of look at two things. One is what percentage ownership are the investors going to have post-financing? And two, how much control are the investors going to have post-financing? And control can either be through being able to vote, which is related to their percentage ownership, or it can be kind of contractual, or provisions in the Certificate of Incorporation. These are the really the protective provisions.

And these are things that you cannot do: the company cannot do without a specific vote of the preferred stock, either voting as a series, if there's more than one series of preferred stock, or voting as a single class of preferred stock. These are things like selling the company, doing a new financing, issuing dividends, those types of things.

It really affects the company's ability to have an exit or do future financing, which are kind of two key areas that you should be focused on when you're doing a preferred stock financing and making sure that the level of investment that you're receiving in connection with the preferred stock financing is commensurate with how much control you're going to give up, both on a voting percentage basis and then also these covenants that we're talking about.

If you violate these covenants, it can result in some dire consequences. You may need to change the board composition, you may need to go out to your preferred stock investors and get their retroactive consent, which they may give, but in return, they may ask for something from the company. So, it's really important that you comply with these covenants.

As a general matter, when we're representing companies, we try to limit these covenants. There are certain terminology or ways that we can draft these to provide the company as much flexibility as we can, but as a general matter, these covenants are pretty standard, and, like I said, it's things like selling the company, doing new financings, kind of key or material transactions that the company is going to enter into which would require the consent of a certain percentage of the holders of preferred stock.

Similarly, we'll talk a little bit about class voting rights and this is what I was alluding to earlier, where the investors have the right to block important corporate transactions, like I said, sale of the company, issuance of the preferred stock, sometimes option grants, and having control over options vesting schedules, which is obviously material to the company. Because as the company, you want to be able to hire people and provide them with the equity incentives that the company's management deems appropriate. But, in some instances, you may have to get consents of the investors to do that.

Another is incurrence of debt or sales or transfers of the technology of the company. As a general matter, when these covenants are present, we try to provide that one, they're done on a class basis, meaning holders of all of the preferred, if there are separate series of preferred, like Series A, Series B, or Series C, we try to lump them all together and have one single vote of all the preferred rather than

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separate series votes where, as an example, you need to get a majority of the Series A, majority of the Series B, majority of the Series C.

Secondly, we try to keep the vote threshold at a majority. In some instances, you'll see the voting threshold depending on who's going to invest and how much they're going to invest being at 60% or 66 and 66 2/3% or even higher in some instances. But, again, from the company's perspective, you want to have a class vote and try to keep the vote at a majority.

Jenna: Up until now, we've really been talking about these terms of the preferred stock and the rights and that the investors have against the company. Another thing to keep in mind when we're talking about preferred stock financings is that there are often stockholder agreements that get negotiated at the time of the investment. These agreements provide certain control for the investor over transfers of company securities and participation in those transfers.

The three main types of protection are the right of first refusal and we see this usually in a right of first refusal agreements. Usually, the founders, sometimes a broader group sometimes encompassing the management team, will sign up to write a first refusal agreement whereby they agree with the company first and the investor second that any transfers of their shares will have to go through a process by which the company can opt to purchase them. Or if the company doesn't want to purchase the shares, then the investors can opt to purchase them.

As a founder, it really limits your ability to transfer your shares and also to get liquidity for your shares. So, for example, in the initial days of the company, if you're taking a lot of your compensation in stock and at some point, you want to see liquidity from that stock, this will be a way that the investors will prevent you from doing that. Similarly, and often in the same document, the investors will reserve for themselves a right where if they opt not to purchase the shares that you as founder want to sell, then they can participate with you in that sale.

Where you may have previously wanted to sell 100 shares to a third party, instead, you may have investors who want to "tag along" on that sale and rather than the 100 shares that you were planning to sell, that 100 shares will have to be divided amongst a number of different stockholders. You'll get less liquidity. And this is a way for the investors to essentially share in any liquidity events that the founders share in.

And finally, the investors often negotiate what we call a drag-along right and that's the right for certain stockholders to require other stockholders to vote in favor of an exit transaction. Typically, the majority of the board have to agree to such a transaction before the drag-along can be triggered, but that's not always the case and we're certainly seeing instances where the only trigger is a certain percentage of the investor syndicate.

And as a founder, this is something that you should pay close attention to because you're really giving up significant power to control the company's destiny. Because if the investors can almost unilaterally decide to sell the company and you're contractually obligated to vote for that transaction, you have a limited say over when the sale event actually occurs.

One way to limit the power of the drag-along provisions is to make sure that the board be involved in

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the determination of whether or not to sell before the trigger can be pulled. Also, some founders may have success in negotiating a say at a founder level so that a certain percentage of the common stockholders would have to also agree before the drag-along can be triggered. That last one is a bit of a tough hurdle to get past with investors because they often then see little value in the drag-along provision itself.

Joe: The next protection that investors get is anti-dilution protection. And fundamentally, what this does is it protects the investors percentage ownership in the company. There's two types of anti-dilution protection. The first one is non-controversial, it's just structural. It means that if the company does a stock split or a stock combination or does a dividend, the conversion ratio of the preferred stock will be adjusted to allow the preferred stock to convert into a proportional number of shares of common stock. Again, this is non-controversial and just mechanical.

The second one is economic or price-based anti-dilution protection, and I'll go into a little bit more detail in a minute. But basically, what this means is if there is a preferred stock financing at a lower price per share, then the price per share at which the current preferred investors bought their shares at, then the conversion ratio on the existing preferred stock is adjusted to make sure that they receive the same number of shares on conversion of their preferred stock to common stock as they would prior to the later down-round. And, again, I'll go into a little bit more detail on this.

There's really two types of economic or price-based anti-dilution protection. There's a full ratchet formula and then a weighted average formula...As an example, let's say the Series A preferred stock is sold at a dollar and let's say the Series B stock is subsequently sold at 50%. On the full ratchet formula, what that means is the Series A preferred stock conversion ratio will go from one to one to one to two.

So basically, they'll get two shares of common stock for every one share of preferred stock that is converted into common stock. The full ratchet formula is not generally used. It is more punitive to the existing stockholders and is generally not done outside of like a down-round or some other kind of extraordinary circumstances.

Weighted average price-based anti-dilution protection is standard and it's based on a formula. So, if the company sells future shares of stock at a price lower than the existing preferred stock, the conversion ratio is adjusted based on a particular formula. And again, that allows the investors to protect their investment and not suffer dilution in the event that the company subsequently sells stock at a lower price than the price at which they purchased their shares.

Jenna: Another way that investors protect their position in a company is through equity anti-dilution and that often takes the form of preemptive rights, rights of first refusal, and rights of first offer. Pre-emptive rights are probably the ones that we see most commonly. This is where the investor can purchase some portion of new securities that are issued by the company.

Securities are usually defined to include both equity securities and debt securities. So, if the company were to do a convertible note round in between two equity rounds, that would trigger these rights for your existing investors. And it's often set so that the investors can maintain their percentage equity interest in the company. So, basically, to maintain their position on cap table of their 20% before financing, they would be able to purchase up to that number of shares that would allow them to

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continue to have 20%.

A right of first refusal is a bit different and this would be different than the right of first refusal that I talked about earlier, which would apply to the founders and other common stockholders. This type of right of first refusal is a right for the investor syndicate to purchase some or all of the equity issued in future financing. So, this can be structured in a way to prevent the company from attracting fresh investors' new money which would be potentially problematic for the company.

The right of first offer is slightly different still and that would be when the company would be required to first go to their current investors with a proposed valuation and terms for new financing. And then after the investors don't agree to participate in that financing, then the company would be free to go and try to find outside investors to invest on the terms that they previously explained to the existing investors.

So, as I said, the preemptive rights are normally what we would see in an early-stage investment particularly. Rights of first refusal and rights of first offer become more complicated and they could put the company in a situation where they would have difficulty attracting new investors. From the company's perspective, we would try to avoid seeing these provisions if at all possible.

Joe: Next, let's turn our attention to board composition. And going back to kind of a common theme throughout this presentation is that whenever you do a financing, you should really think about control of the company post-financing. And one of the major ways that investors can have control over the company is through representation on the board.

Class voting, meaning how many directors do the holders of common stock have the ability to designate, how many members of the board do holders of preferred stock have the ability to designate, are usually set forth in the Certificate of Incorporation. And then there is an accompanying voting agreement which basically says how those particular directors will be elected to the board.

A common voting structure for a Series A financing is that there will be two common directors, two preferred directors, and one independent director. Usually, you want to have an odd number of board members on the board to avoid any type of deadlock on the board. Investor representation on the board usually tracks how much money they've invested. The lead investor or the investor that has invested the most money will usually have their designee on the board.

When we do these financings, we also want to make sure that, to the extent we can, management or the founders also have representation on the board. And ideally, especially in a Series A financing, we would like for the holders of common stock or management or the founders, who are all usually one and the same, to be able to continue to control the board. You would have two common, two preferred, or ideally, three common and two preferred.

You also have what are called independent directors and these directors are people that are not employed by the company and are also not investors. They're usually people with significant industry knowledge in the same industry as the company is operating who can provide guidance to the company, and so on and so forth.

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But from the company's perspective, you want to try, to the extent you can, have these independent directors, although they're independent, really be kind of in the camp of the founders, so you can have some assurance that they're not going to, vote with their wallet, so to speak, and they'll vote consistently with the common holders. Now, that's not always achievable, but it is something to think about when you're composing your board.

Jenna: Moving on now to redemption. Redemption is the investor's right to require the company to buy them out of their investment. It guarantees the investor can get money back after some specified period of time. One thing about redemption is that it is often industry-specific. We see redemption rights much more commonly in life-sciences companies than we do in high-tech companies.

With redemption rights, it generally depends on the stage of the company, the venture fund investing, the business plan, and the profitability model of the company. Typically, we would see a redemption right not kick in for a period of five to seven years from the closing of the financing. So, one thing to keep in mind for subsequent rounds is that you probably want to try to move that redemption date out. If you do a Series A financing, and then two years later, you do a Series B financing, and in each case, you included redemption, you probably want to push the date for redemption out and have it be measured from the Series B closing as opposed to the Series A closing if you possibly can.

The amount paid in redemption is often a dollar of invested plus accrued dividends or some sort of standard return at fair market value or appraised value of the stock that's being redeemed. One thing to keep in mind is that corporate law prevents the company from redeeming shares without a surplus and that's defined in the various corporate codes. There will be situations where an investor or a series of preferred stockholders may have the right to require redemption, but the company is prohibited from acting on that redemption because of the rules that are applicable under this specific corporate law, usually Delaware.

That said, when you have delinquent redemption, there are usually consequences to it. So, the company can incur interest if they're not permitted to redeem on certain specified dates. You may have to increase the conversion rates, so this would be similar to what Joe was talking about earlier with anti-dilution protection.

You may have to increase the number of shares of common stock that the preferred stock could convert into. You may also have to change the composition of the board, so you may lose some control in that aspect and that's the investors' way of exerting more control where the company is not hitting the milestones or achieving the ability to redeem shares when the investors think they should be able to do so.

Joe: Next, registration rights. The registration rights basically provide the investors some ability to have liquidity by participating in a public offering or forcing the company to go public. I'll say from the outset that registration rights are absolutely typical and customary for a preferred stock financing.

There are a few provisions within the registration rights that are negotiated, but generally, they're pretty standard in the market and there's not a whole lot of negotiation that goes on here. If you look at the investors’ rights agreement as an example, you'll see kind of the different provisions that may be somewhat negotiated. But generally, they're pretty standard.

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And there's three types of registration rights. The first type is the demand registration right and this basically says that we, the investors, demand that you register our shares with the SEC and that effectively means that the company has to go public. These are rarely, if ever, used. In doing this for 20 years, I've never seen anybody use demand rights and force the company to go public.

Piggyback registration rights are also fairly common, and, basically, what this says is that the company is going to file for its IPO or it's going to do some other type of registered offering with the SEC. Then they get the piggyback on that registration and include some of their shares in the registration.

Now, basically, what this allows the investors to do is kind of have an orderly and marketed sale of their shares rather than just dumping them into the market, which may result in a depressed stock price. And, again, it allows them to have their shares being sold in a marketed offering.

The last one is what are called Form S-3 short-form registration rights. And what this means is after the company's been public for a year, they're able to use a short-form S-3 to either register the company shares for sale or register investor shares for sale. And it's a cheap short-form way to sell your shares into the market. And these are often used by investors, again, for kind of an orderly sale, especially if an investor holds a large number of shares in the particular company, and they, again, just don't want to start dumping them into the market or they can't dump them into the market because they're restrained by certain rules and regulations. It allows them to use the Form S-3 to sell their shares into the market in a kind of an orderly fashion.

Jenna: The next three slides are items that are of particular interest to founders and managers of companies who are anticipating a bunch of financing. The first slide has to do with the incentive basket for management shares, and, you know, this often takes the form of an option pool or equity pool that is available to employees in the company.

And the key things to keep in mind here are that at the outset, from the beginning of the term sheet stages, you should be getting an agreement from the investors on what percentage of the company you will be setting aside for this pool. And we think about the pool as a way to incentivize and reward the employees and consultants who are driving the company forward. Awards under these pools are carved out of economic and priced anti-dilution, so it would not trigger the calculation that Joe described earlier and the shares would not be subject to preemptive rights or rights of first offer like the first refusal that I described earlier.

The option pool could potentially dilute everyone, so founders or common and preferred alike, but that really depends on when it's implemented. Oftentimes, if you've not implemented a pool or you've used up some of your pool prior to agreeing to a Series A term sheet, the investors will require that you implement the pool or increase the pool prior to the investment. It's almost like a discount against the pre-money valuation because what that does is it increases the number of shares that are counted in the fully diluted number and, therefore, drives the price down when you divide into the pre-money valuation.

There are ways to structure so that it dilutes everyone, but there are also ways to structure it so that it dilutes the only existing stockholders. At the outset of a Series A, that would mostly be the founders,

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and in later rounds, that would be everyone already holding shares, the preferred and common included. And we usually see the pool representing 10% to 25% of the fully diluted post-money capitalization. The percentage really depends on where the company is in its stage of development.

Next slide has to do with the shares that are already held by the founders, sometimes by the managers, and you will often see investors requiring founders and managers to subject their shares to vesting, even those shares that are held by those individuals prior to the financing. And this is one of the reasons why we recommend, when a company is being formed, that everyone subject their shares to vesting from the outset, so that when a company is in a position to start looking to raise their first round of equity financing, there is already a vesting schedule in place that everyone is comfortable with.

Provided that it's a reasonable vesting schedule in that too much time hasn't elapsed since the schedule started, often, the investors will view that as adequate. If you don't have vesting and repurchased rights for the company implemented at the time that you start negotiating your term sheet, then you may have less control over what the investors propose and how they want to subject your shares to vesting.

Some issues to consider include: how much time have you contributed to the company as of the time of investment? What happens if the founder or some stockholder is terminated without cause or has to leave the company because of disability or because of death? How do the shares vest on an annual basis, on a monthly basis, on a quarterly basis? Is there a cliff or not?

What we usually mean by a cliff is there's a certain period of time where, something like a burn-in period, no shares would vest, and then after, say, six months or a year, it'd be a catch up, so you would vest in all of the shares that would have vested up until that first year and then monthly going forward, so 25% on the first anniversary and monthly going forward after that. It's fairly common.

You also might consider what the buyout price would be if the relationship with the company was terminated. Often, founders pay a fraction of a penny for their initial shares and so consideration should be paid to whether that would be a fair repurchase price if the founder's relationship with the company was terminated and the company had the right to repurchase any unvested shares.

Joe: There are a few other kind of notable deal terms and trends that we'll talk quickly about, but not spend too much time on. The first is pay to play and this used to be somewhat prevalent, but now it's really not that common. And what it effectively means that holders of preferred stocks had to participate on a pro rata basis in future rounds the financing, and if they didn't, they would lose specific rights associated with their preferred stock, or their preferred stock could be converted to a shadow or a junior class of preferred stock, or, most punitively, conversion of their preferred stock to common stock.

And basically, what this is intended to do is to not give current investors a free ride on future investments and it was an incentive for current investors to continue to invest and support the company. It's very uncommon to be done on early-stage companies. It becomes more common in later-stage companies, especially if that later-stage company is under some duress. And what that means is if the later-stage company needs money, is not doing really well, and the existing investors need to invest to support that company, they want to make sure all investors put up money to support that company, it's not just a select number of investors to put up the money.

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Sometimes it can be implemented in tranche financings, meaning if they invest in the first closing, but if you don't invest in the second closing, then the shares you bought in the first closing are converted to common or a shadow series or junior series of preferred stock. That's also very uncommon, but it is something to keep in mind, especially if you're a later-stage company. Investors will want to implement that to keep other investors motivated to invest in your company.

Another item of particular note are down-rounds and what a down-round effectively means is that the financing value of the company in the Series B financing, as an example, is lower then what the post-money valuation of the company was at the Series A financing. So basically, the company is not doing well and the value of the company now is lower than the value of the company at the time of the prior investment.

Issuing shares below the share price of a previous series also triggers the anti-dilution protection. So remember that it'll trigger dilution protection for the Series A and that can potentially impact the common holders because if the Series A in our example converts out at a lower conversion price, that means more shares of common are going to be issued upon conversion of Series A and that will be dilutive to all stockholders, including the founders.

Other practical things to consider when you're doing a down-round, and, again, down-rounds occur when basically the company is not doing well, is effect on employee confidence and morale the impact on the company's future fundraising efforts. And some alternatives to doing a down-round is that a lot of times, investors will just do a flat-round and not do a down-round because it's a poor signal to future investors when you do a down-round.

Or they may just bridge the financing or bridge the company, I should say, either through a note or a SAFE. So they don't have to do a down-round now, they can just infuse more money into the company and see if the company can turn it around without having to do a down-round. And, again, that's a better signal to future investors than actually doing a down-round financing.

Jenna: One last thing to talk about when it comes to possible deal terms for an equity financing is tranche financing. This is another one of those terms that we find to trend very heavily in certain industries opposed to others. We see tranche financing much more commonly in life sciences companies, particularly early-stage life sciences companies. A tranche financing, as Joe mentioned earlier, is where the terms of a financing are negotiated ahead of time, but they're pre-determined closing at various periods of time, usually after the company has achieved certain milestones.

And the reason that these financings are done is because there's valuation uncertainty or concerns the investors may have as to the direction of the company and whether the investment is what it purports to be. So, they'll tend to create additional incentives for the company to perform in order to get the rest of the money that the company is looking to receive. It provides some flexibility for the investors and also a decent amount of leverage with respect to those second and probably third and fourth closings.

Things to consider here are whether you should be issuing the same series of preferred stock or whether it should be another series, for example, of Series A1, and A2, and A3 possibly at a different purchase price, presumably an increase in purchase price. Consider what the milestones are and whether they're achievable from practical perspective, whether you believe that you'll be able to achieve those

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milestones within the time allotted. And also who determines whether you've achieved those milestones? Is it just up to the investors to decide? Is it a board decision? Is it a management division?

And then finally, as Joe alluded to, whether there would be any penalties for not participating as required in the subsequent closings. A tranche financing can be structured as an obligation. So, if the company needs certain milestones the investors are required to close or it can be an option. And, for obvious reasons, the structure of the financing should be heavily considered before being agreed to.

And finally, the other ways to finance a company at an early-stage, as Joe talked about earlier, are convertible notes and SAFEs. And the key terms for convertible notes, often, we see these done without term sheets, but if there is a term sheet, you want to consider the interest rates for the note. We typically see anywhere from 5% to 8%. There are outliers, but generally, that's the trends that we're seeing. Maturity dates, as Joe said earlier, that's when the note comes due. So typically, we'll see 12 to 24 months depending on the stage of the company and when the company expects to do their next financing.

The big basic thing to think about is the conversion discount and cap. The conversion discount is the discount off of the per share price that the note holder will receive when and if the company does an equity financing. For example, if you gave a 20% discount in the Series A shares, it will convert their notes into Series A shares at 80 cents a share. Discount on the next round is very common when we're talking about convertible notes.

Caps are becoming increasingly common. A cap is when the investors will convert at the lesser of the discounted share price or the price that would be achieved if the pre-money valuation was X. And there are two problems here. First of all, the benefit of doing a convertible known is often that you kick the valuation question down the road and this requires you to consider the valuation of the company. Also, it hurts the company for success. So, you disengage incentives when you create a cap and it's a difficult thing to renegotiate once it's already been agreed to. Often consider events of default and whether a note is secured or non-secured.

Joe: And lastly, SAFEs. And, again, SAFEs are very similar to convertible notee, but it's not debt, which means it doesn't have a maturity date, which, again, relieves that pressure to get a financing done. There's no interest component, so from an economic standpoint, it's better for the company because you don't have to pay interest.

State lending regulations are now applicable and there's no debt protection. What that means is if there's a liquidation of the company, SAFE holders don't get paid out first necessarily. Sometimes, there's a contractual right to get paid off first, but by law, they're not obligated to be paid off first. They're simple. You can accommodate discounts caps, those types of things. They're very standard. They're not really negotiated hardly at all.

A couple of things to consider is having a majority amendment provision, which means that if you need to amend the SAFEs, you don't have to go out to each individual holder to get their consent to amend. Rather, you go out to a percentage of the holders of the SAFEs to get their consent to amend.

And the last item is participation rights and that's the right to basically participate in future financings.

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And while that may not seem like a big deal, because if they want to invest, they can, if they don't, they don't, but in many instances, SAFEs are being issued in a relatively small amount to a number of investors and it becomes somewhat unwieldy if you have a large number of SAFE holders having the ability to participate in future rounds. You really want to be cognizant as to whether or not that person is putting in enough money now to warrant the right to participate in future financings.

Lastly, and probably most importantly, the thing to remember on convertible notes and SAFEs—it's becoming more and more market to have the shares that would be issued upon conversion of the SAFE or notes be included in the pre-money capitalization of the company. As an example, if you take the SAFEs, you would take the number of shares that would convert out or be issued upon conversion of the SAFEs and you would put that back into the pre-money capitalization of the company for purposes of determining the Series A price and the number Series A shares to be issued.

What that effectively means is those conversion shares are diluting the founders only and not the new investors. You could find yourself in a particular difficult situation if you have a large dollar amount of SAFEs outstanding and the investors are insisting on including the conversion shares in the pre-money. It could be extremely dilutive to the founders. The takeaway should be that if you're using the SAFE or convertible notes, they really should be used for seed financings in small amounts—500,000, maybe a million, but probably nothing north of that, because it could be if you do issue them in a greater dollar amount, it could end up being extremely dilutive to the founders.

Jenna: We've gotten a few questions. The first question is what happens when a note is due and the company has no money to pay it?

Joe: I can take that one. There are probably three scenarios that happen in that situation. The first scenario is the investor is just willing to extend the maturity of the note because they want to continue to support the company and the investor doesn't ask for anything in return. And that's somewhat common.

The second scenario is the investor is willing to extend the maturity date on the note, but they want something in return. And I think that this is more common than the first scenario. And what they often ask for in return is a greater discount on conversion. They may ask to lower the cap, they may ask for a greater premium on a sale of the company or certain other kind of economic rights that basically enhances the deal from the investor's perspective.

The third scenario, which I think is extremely uncommon, is they could force you into bankruptcy. That usually doesn't happen because one, it can be expensive, and two, if the company doesn't have the ability to repay the note, that generally means that the company may not be doing that well, which also generally means that the value of the assets of the company will not be sufficient even if you are forced into bankruptcy to repay the note. So that one is very uncommon. Usually, what happens is scenario one or two.

Jenna: Another question about convertible notes. With regards to the convertible notes option, how common is it to offer warrants instead of a conversion discount? In my experience, I see warrants very infrequently. I think discounts have really supplanted the warrants options. I'm curious if you're seeing anything different, Joe.

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Joe: No, I usually see it on the conversion, Now, the math is a little bit different between the warrants and the conversion discount, but I usually see just the conversion discount and not the warrant.

Jenna: The last question we have is about tranche financing. And the question is whether later charges of the transference is included in the fully diluted number. The answer there is no, they're not. The fully diluted number really is only applicable to determining the price per share and so the price per share calculation is being done at the beginning prior to the money coming in. The obligation of the investors to purchase in later rounds would not really impact the cap table unless and until those shares are purchased.

That brings us to the conclusion of our presentation today. Thank you all very much for joining us. We hope you'll join us for our next session on May 16 when our colleagues will discuss secondary sales. You'll receive information about that topic in the coming weeks. If you have any additional questions about any of the topics discussed today, please feel free to reach out to me or Joe directly. Thank you again for your attendance and for your participation.

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