LATHAM & WATKINS LLP

Seminar Series: Startup Law 101 for Entrepreneurs

Idea to Exit: Financing

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Ways to Finance the Company

Self-fund: use your own cash to build your company

Angel/Seed financing: issue debt in exchange for cash from friends, family and angel investors

Venture financing: issue equity in exchange for cash from institutional investors

Pros and Cons of Different Types of Financing

	Self-Fund	Convertible Notes	Preferred Stock
Pros	• Allows company to defer valuation • No initial loss of ownership	• Allows company to defer valuation • No initial loss of ownership – debt v. equity • Scaled raises of funds • Cheaper and less time consuming than preferred stock financings	• Larger financing • Value of VCs as advisors • Successive participation of VCs in later rounds • Single or few professional investors
Cons	• It's your own cash	• Drawbacks of debt instruments • Dilution may still occur if lenders convert • Difficulty of multiple lenders ("herding cats") • Lenders less sophisticated than VCs	• Founders lose some control of the company (and must respect rights of preferred holders) • Requires valuation of the company • More expensive and time consuming

Raising Funding…

Convertible Note

What is it?

Short-term debt that converts into equity

The Term Sheet

[NEWCO, INC.]

SUMMARY OF PROPOSED TERMS FOR
CONVERTIBLE PROMISSORY NOTE (BRIDGE) FINANCING

The following is a summary of the basic terms and conditions of a proposed convertible promissory note financing of [Newco, Inc.], a [Delaware] corporation (the "***Company***"). This term sheet is for discussion purposes only and is not binding on Company or the Investors (as defined below), nor is Company or any of the Investors obligated to consummate the convertible promissory note financing until a definitive convertible note purchase agreement has been agreed to and executed by Company and the Investors.

Financing Amount:	Up to $__________[1] in aggregate principal amount of convertible promissory notes (the "***Notes***").
Closings:	The Company may close the sale of the Notes in one or more closings with one or more purchasers of the Notes acceptable to the Company (the "***Investors***").
Definitive Agreement:	The Notes will be issued and sold pursuant to a convertible note purchase agreement prepared by the Company's legal counsel and will contain customary representations and warranties of the Company and the Investors (the "***Note Purchase Agreement***").
Maturity Date:	Principal and unpaid accrued interest on the Notes will be due and payable _____[2] months from the date of the Note Purchase Agreement (the "***Maturity Date***").
Interest:	Simple interest will accrue on an annual basis at the rate of _____%[3] per annum based on a 365 day year.
Conversion to Equity:	Automatic Conversion in a Qualified Financing. If the Company issues equity securities ("***Equity Securities***") in a transaction or series of related transactions resulting in

- Applies to both convertible notes and preferred stock
- The "engagement ring" of the financing process
- Summarizes the principal legal and business terms of the financing
  - Details are found in the Charter and financing agreements
- Typically non-binding
- You should be aware of what terms are important to negotiate

Convertible Notes – Pros and Cons

- Pros
  - Allows company to defer valuation
  - No initial loss of ownership – debt v. equity
  - Scaled raises of funds
  - Cheaper and less time consuming than preferred stock financings
- Cons
  - Drawbacks of debt instruments
  - Dilution may still occur if lenders convert
  - Difficulty of multiple lenders (“herding cats”)
  - Lenders less sophisticated than VCs

Critical Terms for Convertible Notes

Maturity Date

- The date on which the debt is due or converted to equity
- Typically should not be more than a year

Interest Rate

- The rate at which the debt will accrue interest, typically on an annual basis
- Usually 3-6%

Conversion Price

- The price at which the note (plus accrued interest) would convert into shares of preferred stock

Conversion Discount

- Mechanism for noteholders to convert the note (plus accrued interest) at a reduced price (in percentage terms) to the purchase price paid by the investors in the next equity financing

Critical Terms for Convertible Notes (cont.)

Uncapped vs Capped

- Capped = ceiling on the valuation at which investors' notes convert to equity (which protects the noteholders' stake when they convert to equity in the future equity round)
- Uncapped = noteholders get no guarantee of how much equity their note purchases (more favorable for company)

Warrant Coverage

- Warrants to purchase additional shares in next equity financing
- Not as common given more paperwork and higher legal fees

Pre-Payment

- Timing
- Penalty

Security Interest

- Enforceable claim or lien that gives the beneficiary of the security interest certain preferential rights in the disposition of secured assets
- Convertible notes are typically unsecured by any assets of the company

Subordination

- Reflects the priorities in claims for ownership or interest in various assets
- Convertible notes are typically subordinate to all other company debt

Preferred Stock

What is it?

A class of equity ownership in a corporation that has a higher claim on the assets and earning than common stock

Preferred Stock – Pros and Cons

- Pros
  - Larger financing
  - Value of VCs as advisors
  - Successive participation of VCs in later rounds
  - Single or few professional investors
- Cons
  - Founders lose some control of the company (and must respect rights of preferred holders)
  - Requires valuation of the company
  - More expensive and time consuming

Considerations for VC Financings

- What do we (the founders) want from a VC?
  - Sophisticated guidance
  - Valuable sources of contacts and expertise
  - Potentially successive rounds of financing
  - But don’t forget the drawbacks:
    - Loss of some control
    - Potentially divergent visions for the company (e.g., timing of IPO or sale of the business)

- How can we gauge our valuation?

- What terms should we be concerned with?
  - Contractual Dilution
  - Board Composition
  - Liquidation Preference
  - Protective Provisions

The Term Sheet

- Terms of the initial round tend to stick in future rounds – think carefully about the critical terms and work with your counsel to negotiate them

TERM SHEET
FOR SERIES A PREFERRED STOCK FINANCING OF
[*INSERT COMPANY NAME*], INC.
[____ __, 20]

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [__________], Inc., a [Delaware] corporation (the "**Company**"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality [and Counsel and Expenses] provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors. This Term Sheet shall be governed in all respects by the laws of [______________the].[1]

Offering Terms	
Closing Date:	As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the "**Closing**"). [*provide for multiple closings if applicable*]
Investors:	Investor No. 1: [_______] shares ([__]%), $[_________] Investor No. 2: [_______] shares ([__]%), $[_________] [as well other investors mutually agreed upon by Investors and the Company]
Amount Raised:	$[________], [including $[________] from the conversion of principal [and interest] on bridge notes].[2]
Price Per Share:	$[________] per share (based on the capitalization of the Company set forth below) (the "**Original Purchase Price**").

[1] The choice of law governing a term sheet can be important because in some jurisdictions a term sheet that expressly states that it is nonbinding may nonetheless create an enforceable obligation to negotiate the terms set forth in the term sheet in good faith. Compare *SIGA Techs., Inc. v. PharmAthene, Inc., Case No. C.A. 2627 ((Del. Supreme Court May 24, 2013)* (holding that where parties agreed to negotiate in good faith in accordance with a term sheet, that obligation was enforceable notwithstanding the fact that the term sheet itself was not signed and contained a footer on

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Critical Terms for Preferred Stock *(cont.)*

Valuation

- Pre-money = estimated value of company prior to accepting funding
- Post-money = pre-money valuation + new funding amount
- Don’t forget the option pool, equity reserved for future distribution to hires, which is often included in the pre-money valuation and thus will directly affect the founders’ equity stake

Sample Valuation Model – The Founders + Option Plan + *First Round of Preferred Funding*

- The company successfully completes a $4,000,000 Series A **Preferred** Stock Financing at a purchase price of $1.00 per share
- Pre-money valuation is $1.00 x 6,000,000 = $6,000,000
- Post-money valuation is pre-money valuation + amount invested = $6,000,000 + $4,000,000 = $10,000,000
- Pretty typical for option pool to be 20% of the fully diluted capitalization

Entity	# of Shares	Pre-Series A % of Shares	Post-Series A % of Shares	Value
Jack	2,000,000	33.33%	20%	$2,000,000
Jill	2,000,000	33.33%	20%	$2,000,000
Option Plan	2,000,000	33.33%	20%	$2,000,000
Series A Investors	4,000,000	0%	40%	$4,000,000
Total		100%	100%	$10,000,000

Critical Terms for Preferred Stock *(cont.)*

Liquidation Preference

- The terms that determine the order in which creditors/shareholders are paid in the event of a liquidation event (IPO, sale or bankruptcy)
- Creditors → Preferred Stockholders → Common Stockholders
- Usually a multiplier (such as 1x)
- Non-participating vs Fully participating (more on next slide)

Critical Terms for Preferred Stock *(cont.)*

Non-participating vs Fully participating vs Capped participation

- Fully participating means that the preferred stockholder with this right receives full liquidation preference amount first and are then entitled to share with the holders of common stock in the remaining amount
- Non-participating means there is no additional amount after the full liquidation preference amount
- Capped participation means the preferred stockholder with this right stops participating after it has received back a pre-determined dollar amount
- See examples on next slide

Critical Terms for Preferred Stock: Liquidation Preference - Participation

- Jack and Jill sell the company for $500,000,000
- Series A investors has a liquidation preference of $4,000,000
- Series A preferred stock representation 40% of the outstanding shares

Participation	Preferred before Participation	Preferred after Participation	Common
Non-Participating	$4 million	$4 million	$496 million
Fully Participating	$4 million	$4 million + 40% of ($500 million - $4 million) = $202.4 million	$297.6 million
Capped Participation (for example, 3x)	$4 million	$4 million + $12 million = $16 million	$484 million

Critical Terms for Preferred Stock *(cont.)*

Voting Rights

- Board seats
- General matters v. Special matters
- Drag along

Critical Terms for Preferred Stock *(cont.)*

Protective Provisions

- Consent of preferred class required for certain actions/events
  - Altering rights of preferred
  - Increasing/decreasing amount of common or preferred stock
  - Creating senior or pari passu classes of stock
  - Merger or sale of the company
  - Increasing/decreasing the size of the board

Anti-dilution Provisions

- Adjustment to conversion price of preferred
- Types
  - Broad-based weighted average
  - Narrow-based weighted average
  - Full ratchet
- Carve outs of certain types of issuances

Critical Terms for Preferred Stock *(cont.)*

Pay-to-Play

Redemption Rights

- Optional v. Mandatory

Registration Rights

- Demand
- Piggyback

Management and Information Rights

Critical Terms for Preferred Stock *(cont.)*

Co-sale

- Investors may sell portion of stock if founders sell their stock

Right of First Refusal

- Right to purchase shares before transferred to third party

Pre-emptive Right

- Right to participate in future issuances

Questions?

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