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Cooley U: Term Sheets

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Today's Topics

- Convertible Notes
- Valuation Issues
- Equity Terms
 - Board of Directors
 - Liquidation Preferences
 - Option Pools & Vesting
- More Than Just Valuation!
 - Protective Provisions
 - Redemption Rights
 - Preemptive Rights
 - and so much more!

Convertible Notes

- Key items of negotiation
 - Interest Rates (4-8%)
 - Maturity Date (12 to 24 months)
 - Conversion Discount or warrants (20-25%)
 - Valuation Cap – Key to the deal!
- Generating a Term Sheet and docs on www.CooleyGO.com
 - Forces you to think ahead
 - Your homework assignment from today!

Valuation Details – Base Case

“Pre-Money” Valuation:	\$7,000,000			
Post-Financing Option Pool:	20.0%			
Total Financing of:	\$3,000,000			
\$7M "pre-money <u>including options</u>"		Before Money	After Money	After Options
New Investors: (@\$0.714/share)	4,200,000	0.0%	37.5%	30.0%
Option Pool:	2,800,000	0.0%	0.0%	20.0%
Founders:	7,000,000	100.0%	62.5%	50.0%
	14,000,000	100.0%	100.0%	100.0%

Bottom Line: You thought you were selling 30%, but it really cost you 50%!

How the Discount and Cap Compute

- Assume you sold \$1.0M of Convertible Notes
 - 5% interest, 20% discount, \$5M cap, 12 months outstanding
- \$3.0M Series Seed at a \$10M post (like before)
 - Only you have to convert the notes
- Your ownership goes from 50% to 37%
- The Best Tool: <http://ownyourventure.com/equitySim.html>

Valuation Details – with a Note

“Pre-Money” Valuation:	\$7,000,000				
Post-Financing Option Pool:	20.00%				
Total Financing of:	\$3,000,000	\$0.5280 per share			
\$7M "pre-money <u>including options</u>"		Before Money	After Money	After Options	Value
New Investors:	5,681,818	0.00%	37.52%	29.99%	\$3,000,000
Note Conversion (no cap)	2,462,121	0.00%	16.26%	13.00%	\$1,300,000
Option Pool:	3,800,000	0.00%	0.00%	20.06%	\$2,006,400
Founders:	7,000,000	100.00%	46.22%	36.95%	\$3,696,000
	18,943,939	100.00%	100.00%	100.00%	\$10,002,400

Series Seed or Series A Terms

- The Biggest Issue: Valuation
 - Multiple Bidders
 - Traction
 - Opportunity Size
 - Convertible note dilution!

Valuation Details – with a Note

“Pre-Money” Valuation:	\$7,000,000				
Post-Financing Option Pool:	20.00%				
Total Financing of:	\$3,000,000	\$0.5280 per share			
\$7M "pre-money <u>including options</u>"		Before Money	After Money	After Options	Value
New Investors:	5,681,818	0.00%	37.52%	29.99%	\$3,000,000
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Option Pool:	3,800,000	0.00%	0.00%	20.06%	\$2,006,400
Founders:	7,000,000	100.00%	46.22%	36.95%	\$3,696,000
	18,943,939	100.00%	100.00%	100.00%	\$10,002,400

Valuation Matters!

“Pre-Money” Valuation:	\$15,000,000				
Post-Financing Option Pool:	20.00%				
Total Financing of:	\$5,000,000		\$1.3850 per share		
\$15M "pre-money <u>including options</u>"		Before Money	After Money	After Options	Value
New Investors:	3,610,108	0.00%	25.00%	25.00%	\$5,000,000
Note Conversion (no cap)	938,628	0.00%	6.50%	6.50%	\$1,300,000
Option Pool:	2,890,000	0.00%	0.00%	20.02%	\$4,002,650
Founders:	7,000,000	100.00%	48.48%	48.48%	\$9,695,000
	14,438,736	100.00%	100.00%	100.00%	\$19,997,650

Series Seed or Series A Terms

- Other Key Issues
 - Board of Directors
 - Liquidation Preferences
 - Option Pool size
 - Founder Vesting
- Generating Series Seed docs on www.CooleyGO.com

Board of Directors – Key Terms

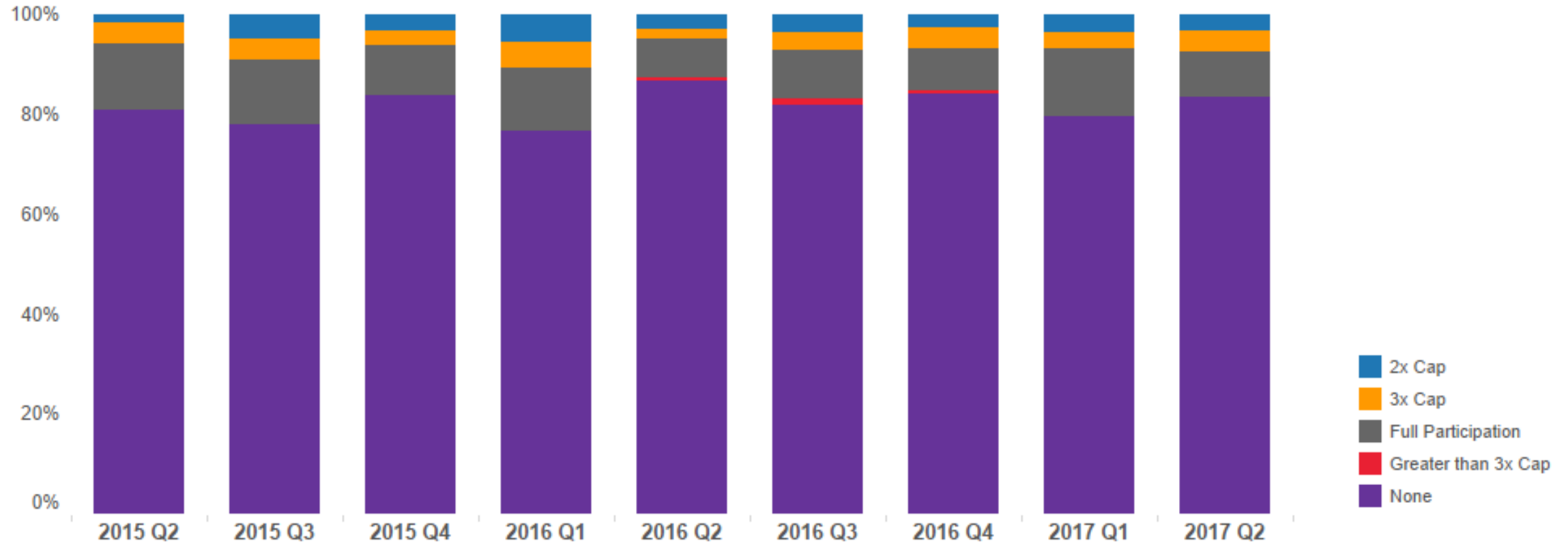
- Size of board
- “Founder” representation vs. CEO
- VCs vs. outsider appointments
- Voting agreements

Liquidation Preferences

- Non-Participating – Investors must choose between Common and Preferred
- “Fully” Participating - 1X plus share of what is distributed to Common Stock
 - Most common in Series A
 - The investors do not need to choose to convert in order to get preference and participation
- Capped-Participation – 1X plus share of what is distributed to Common Stock, unless a cap is reached (e.g. 3X total); investors must choose to convert to avoid being capped
- What do you mean more than 1X!
 - Rare on West Coast; Utilized in late or down rounds

Liquidation Preferences

Liquidation Preference: Participation Features



Liquidation Preferences

Let's go with the numbers we had earlier.

\$3MM financing on a \$7MM pre-money that included the 20% pool.

"Pre-Money" Valuation:	\$7,000,000			
Option Pool:	20.00%			
Total Financing of:	\$3,000,000	\$0.7140 per share		
\$7M "pre-money including options"		Before Money	After Money	After Options
New Investors:	4,200,000	0.00%	37.50%	30.00%
Option Pool:	2,800,000	0.00%	0.00%	20.00%
Founders:	7,000,000	100.00%	62.50%	50.00%
	14,000,000	100.00%	100.00%	100.00%

Liquidation Preferences

- Sale without Participating Liquidation Preference

Sale in 13 months		\$7M "pre-money <u>including options</u>"	
Total Sales Price	\$20,000,000		
\$7M "pre-money <u>including options</u>"		After Options	Effective Proceeds
New Investors:	4,200,000	30.00%	\$6,000,000
Option Pool:	2,800,000	20.00%	\$4,000,000
Founders:	7,000,000	50.00%	\$10,000,000
	14,000,000	100.00%	\$20,000,000

Liquidation Preferences

- Sale with Liquidation Preference

Sale in 13 months		\$7M "pre-money including options"	
Total Sales Price	\$20,000,000		
	Liquidation Preference	Remaining Balance	Effective Proceeds
New Investors:	\$3,000,000	\$5,100,000	\$8,100,000
Option Pool:	\$0	\$3,400,000	\$3,400,000
Founders:	\$0	\$8,500,000	\$8,500,000
	\$3,000,000	\$17,000,000	\$20,000,000

- Investors get their original amount first
 - Remaining Balance split among all stockholders
 - Net is investors get 2.7X return on 2X deal.

Option Pools and Vesting

- Option Pools
 - Typically specified as a % of the fully diluted
 - Best if you have a plan and “budget”
 - Investors will frequently require specific vesting schedule
- Vesting
 - Term (4 years is typical) and “cliff” (1 year)
 - Founders and re-vesting
 - Single and double triggers for accelerating vesting
 - Single: “The company is sold.”
 - Double: “The company is sold and you are fired.”

Other Key Points to Negotiate

- No Shop
 - One of the only binding terms in the term sheet
 - Confidentiality is the other
- Information Rights
 - Definition of a “Major Investor”
 - Time for audited financials!

What The Heck Are These?

- Protective provisions
 - Your investors control the future
- Redemption rights
 - Rarely included, even rarer to use
- Preemptive rights
- Drag -along rights
 - One for all, and all for one

The Boilerplate

- Registration Rights
 - Impact is far into the future (potentially) or when you are at the IPO stage
- Dividend Rights
 - Preferences
 - Cumulative vs. non-cumulative
 - When, if, how, maybe
- Co-Sale Rights
 - Everyone gets out at the same time

Other Things to Know

- What is a “Lead Investor”
 - Not a legal term
 - No compensation involved
- Costs and Fees
 - Company Counsel
 - Investor Counsel
- Making it go fast
 - Understanding your cap table!
 - Setting up a data room
 - Cleaning up your past
 - Communicating with your team