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Understanding Early-Stage Deal Terms

About the Authors

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Preface

Hambleton Lord &
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We live in a world where you can buy stocks in publicly traded companies at the click of a button. Purchasing 100 shares of Apple is easier than purchasing a bottle of wine at your local wine merchant. Maybe some day in the future purchasing stock in an early stage, private company will be just as easy.

But today, we are a long way from having private company stock transactions this streamlined. Each private deal is custom-crafted, and it takes considerable time and energy to negotiate the deal and produce the investment documents.

The **Term Sheet** is the document that starts it all. Crafting a term sheet is how most of the real negotiation between investor and company occurs. It can be a challenge to properly account for and allocate the many risks and benefits in an early stage deal. So both sides of the table need to know what terms do which things. It's also very helpful if the attorneys on both the investor and company side are experienced in drafting these types of investment documents.

This book on Term Sheets and Deal Documents will outline key concepts you should master so you will become a better, more informed investor. You will learn the following:

- What are the four key subject matter areas in a term sheet
- When negotiating a term sheet, what are the biggest concerns for investors and what are the biggest concerns for founders
- Which deal terms will have the biggest impact on your financial outcomes
- Which deal terms provide you with a say in critical business decisions for the company
- Besides the Term Sheet, what documents will you see as part of your investment

Having negotiated over 100 early stage investment term sheets, we are able to cut through the clutter of dense legal documents. We expressly designed this book as a practical outline for investors and not a treatise for law students or first year associates.

So read on... and learn how experienced investors think about and structure their deals.

Chapter 1

Angel Fundamentals: Understanding Equity Deal Terms

Active angels work with term sheets regularly, but not every investor fully understands the sometimes arcane language in these highly-specialized documents. What are term sheets? What do they signify? Why are they so important?

If you walk through the first six chapters of this book with us, we will explain. Although it is a fairly complex subject, we have a relatively simple framework we use to help all early stage investors understand term sheets better and retain and apply that understanding in real life deals.

Non-Binding; Summary Instructions

Most early-stage investments start with or are accompanied by a "term sheet" summarizing the terms of the deal. Unless a term sheet expressly states that it contains legally binding sections, early stage investment term sheets are not legally binding agreements. Instead, term sheets can be thought of more like a set of notes outlining the principal elements of the deal as agreed by the negotiating parties. They serve as a basis for soliciting interest from prospective investors as well as a guide for use by counsel drafting up the definitive binding documents.

The problem is that they can be dense and complex. Term sheets can cover literally dozens of subjects. They are written in very jargon-heavy shorthand so they can be quite intimidating for less-experienced investors. You will see provisions on everything from price, size of round, composition of the board to liquidation preferences, and anti-dilution protection.

> Unless a term sheet expressly states that it contains legally binding sections, early stage investment term sheets are **not legally binding** agreements.

Framework: Four Key Areas of Concern

But these documents do not need to be overwhelming because all term sheet issues can be grouped into four basic areas. Within those areas, the individual provisions can be thought of as a group of tools representing a negotiated balancing or risk allocation between the concerns of the founders and the concerns of the investors. So what are those four key areas?

- Deal Economics
- Investor Rights / Protection
- Governance, Management & Control
- Exit/Liquidity

Deal Economics - Investors want to make sure they get a big enough slice of the pie to make the investment worthwhile on a risk-adjusted basis. They want to make sure they get paid back first. They want to put a time-clock on the founders. And they want to make sure employee options don't dilute them inappropriately.

Investor Rights / Protection - Investors want to make sure no future financing deals contain terms which unduly diminish the value of their investment or lead to someone moving into a superior liquidity position (without paying appropriately for that right).

Governance, Management & Control - Investors want to know what's going on in the company, have a say in critical decisions, and they want to protect against founder behavior that could be damaging to the company.

Exit/Liquidity - Investors want to make sure they maximize the chances to get their money back in all possible exit scenarios, even if they have to force such a situation to occur.

Fair, All Things Considered

Those goals may strike an observer as greedy (or at least aggressive) but they are not really when you consider how equity investment deals work. Unlike lenders, who have a legally-enforceable right to be repaid (often further secured by collateral or guarantees), investors purchase equity on no-recourse terms. If a company fails, the equity is worthless. Absent fraud or misdeed, equity investors have absolutely no right to be repaid. Thus investors are fully assuming the risk of failure of the venture, proportional to the amount of money they put into it. The only way they get their money back is for two things to happen in sequence:

1. The company to make progress and become more valuable and
2. An opportunity to arise in which investors can sell their stock in the company to a third party for more than their original purchase price.

In that sense, equity investment can be thought of as somewhat like a loan that the ultimate acquirer of the company is expected to repay.

Hard-Learned Lessons

Once looked at through this lens, the many provisions of a term sheet begin to make more sense and seem more reasonable. They provide protections for the many company development potholes and speed bumps experience has taught investors to expect. Whether a given term sheet represents a perfectly fair compromise is a function of the market and investing dynamics around a particular company at a particular time. Nevertheless, the term sheet negotiation process is always a constructive way to air and address the tension between investors' concerns and founders' concerns.

> Absent fraud or misdeed, equity investors have absolutely no right to be repaid. Thus investors are **fully assuming the risk** of failure of the venture, proportional to the amount of money they put into it.

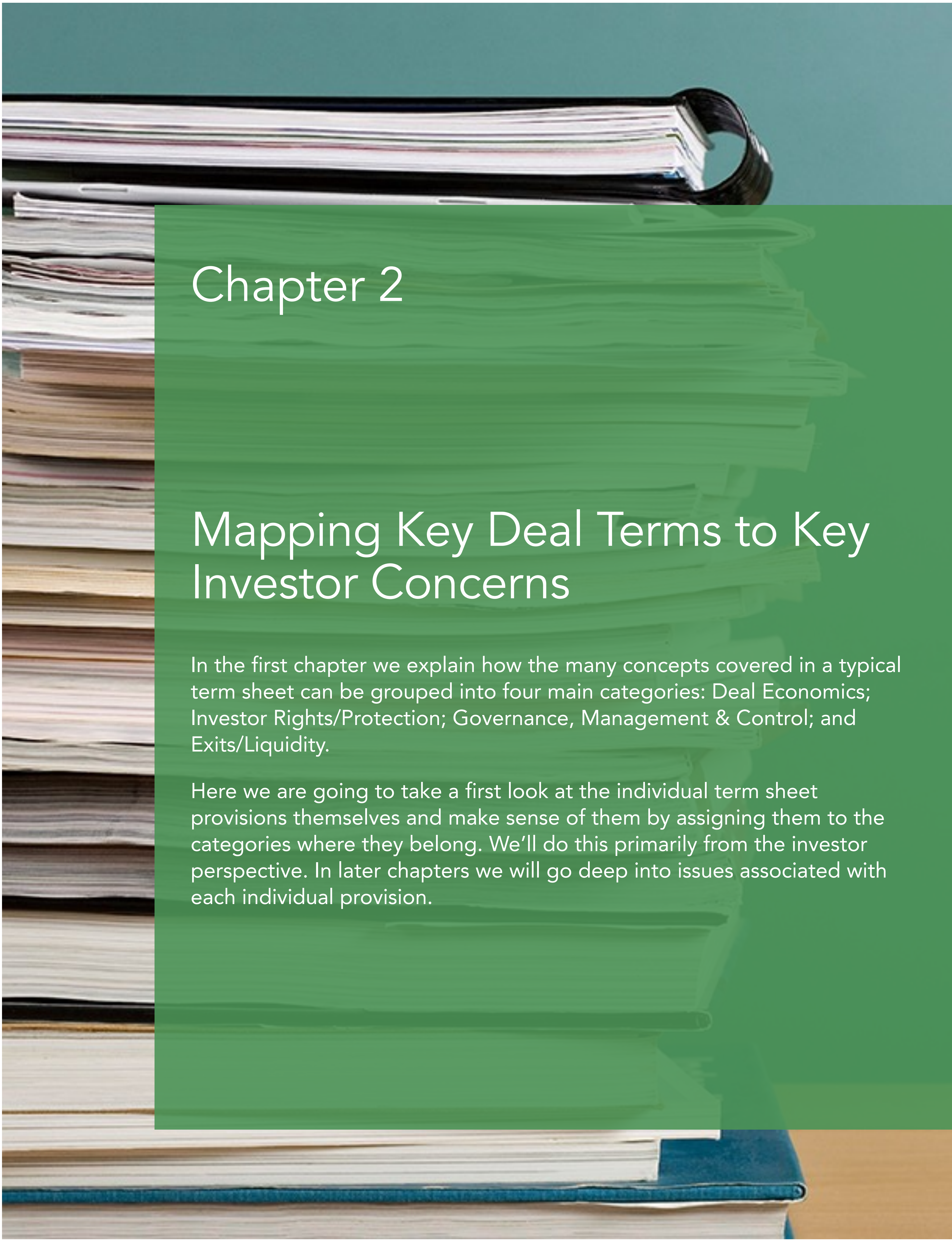
Founders' Concerns

That was a quick overview of the investors' concerns, but while contemplating taking on investors in their company, founders have their own set of concerns and are worrying about a different set of issues.

- They do not want to lose control of the company, either by selling too great a percentage of their company or by agreeing to overly powerful contractual control provisions.
- They do not want to be economically washed out by selling too much of their holdings too cheaply.
- They do not want to lose ownership of their shares if they are fired or resign.
- They do not want their company to run out of money and shut down.
- They do not want to give personal guarantees or put up their home or other assets as collateral; and
- They worry about the fit with and value-add from their investors.

The Value In The Term Sheet Process

So when investor concerns meet founder concerns, you clearly have the potential for strong tension between positions. One important role the term sheet formation process plays is to identify all the key issues and allocate the various risks between the parties. If you are successful, you will come to, and record, a negotiated middle ground on the various issues. Continue reading this book to learn how the various individual provisions work in doing exactly that.



Chapter 2

Mapping Key Deal Terms to Key Investor Concerns

In the first chapter we explain how the many concepts covered in a typical term sheet can be grouped into four main categories: Deal Economics; Investor Rights/Protection; Governance, Management & Control; and Exits/Liquidity.

Here we are going to take a first look at the individual term sheet provisions themselves and make sense of them by assigning them to the categories where they belong. We'll do this primarily from the investor perspective. In later chapters we will go deep into issues associated with each individual provision.

Deal Economics

When you think about the basic economics of a round of investment, clearly the total size of the round is a key question, as is the valuation of the company; specifically, the valuation the investor agrees to before investing. The higher the valuation, the greater the price per share, and the fewer the number of shares (and percentage of the company) will be acquired for a given investment.

A closely linked issue is the size of the option pool - investors want to invest in a company which has the tools necessary to attract and retain talent (i.e. employee stock options) and the investors want the company to establish that pool prior to their investment so that the creation of the pool does not dilute their ownership and raise the effective valuation of the deal.

> Depending on how the **liquidation preference** is structured, and what the exit price is, sometimes it is better to take the preference and sometimes it is better to **convert** to common.

This deal economics category is also where you are going to find discussion of the liquidation preference or repayment priority associated with the shares on offer. Preferred stockholders are always entitled to repayment before common stockholders, but the liquidation preference provision specifies key details: whether they are entitled to more than 1X their original money, and whether they are entitled to participate with common after they have been paid back their original principal. Liquidation preference clauses generally give the preferred holders a choice of taking their preference or converting to common. Depending on how the liquidation preference is structured, and what the exit price is, sometimes it is better to take the preference and sometimes it is better to convert to common. With participating preferred you get a bit of both - you take your original principal back and then convert and participate with common.

Dividends are the final item you sometimes see addressed in the deal economics category. It is highly unusual for a startup to agree to regular cash dividends, but accruing dividends or dividends payable in stock are often seen. Dividends function as a way to keep a time clock on the entrepreneurs to make sure there is some compensation for the passing of time.

Investor Rights/Protection

The most important topic in this category is the anti-dilution provision. This clause prevents the company from diluting investors by selling stock to someone else for a lower price than the earlier investor paid. The anti-dilution clause states that the investors' stock will be repriced downward (and they will therefore own more shares for their original investment) if stock is offered to others at a lower price. More on this complex clause later.

The anti-dilution provision is strong medicine, but indirect. The other provisions in this investor rights category attempt to control behavior more directly. The first is an assertion of the right to approve any material merger, acquisition or liquidation of the company. Because of this approval right, the transaction cannot be done without investor permission. So, the investors know they will be asked to approve a transaction in advance and can be sure they will not be surprised by a transaction after the fact.

Working in parallel are similar provisions controlling transactions involving the company's stock. The first reserves the right on behalf of investors to participate in any future financings, so that if things are going well, current investors will have the right to invest more. The second relates to secondary stock transactions - stock sold by a founder rather than by the company itself. This provision pairs two opposing sides of the same coin: a right of first refusal (ROFR) and a co-sale right. What these provisions say is that if a founder is selling any of their stock, first, the investors (or the company) will have a right of first refusal to buy that stock before it is sold to a third party. However, the investors may not want that stock, because things might not be going well, so, second, the investors pair the ROFR with an alternative right: the right to sell a proportionate amount of their own stock in any transaction that the founders are able to pull off. This way the investors are covered no matter what the transaction scenario is.

Governance, Management & Control

This category addresses the reality that investors want to know what's going on in the company, have a say in critical decisions, and want to protect against founder behavior that could be damaging to the company. Thus, the heart of this category is the right to one or more investor board seats, combined with governance provisions requiring board or committee approval for a list of important operational activities (or even in some cases reserving a veto right for the investor board member).

Paired with this in the governance category is the clause called information rights. These rights involve a requirement that the company regularly share with investors information on the company's financial and business condition.

Investors want to know what's going on in the company, have a say in **critical decisions**, and want to protect against founder behavior that could be **damaging** to the company.

The final concepts in this section have to do with managing the risks associated with relying on key founders to make the company successful. The first goes under the misnomer "founder vesting". It is a misnomer because it's actually a right to claw-back some of the founder's stock in the event that the founder leaves the company in the early critical years. The right phases out over time, so it is really not vesting of ownership, it is lapsing of restrictions. Related to this is the requirement (in jurisdictions permitting it) that founders as well as other employees sign agreements not to compete with the company, use its confidential information, and/or poach its employees for a period of time following their departure.

Exits & Liquidity

The final category of clauses relates to the control of exits and liquidity; investors want to make sure they maximize the chances of getting their money back in all possible exit scenarios (positive or negative), even if they have to force such a situation to occur.

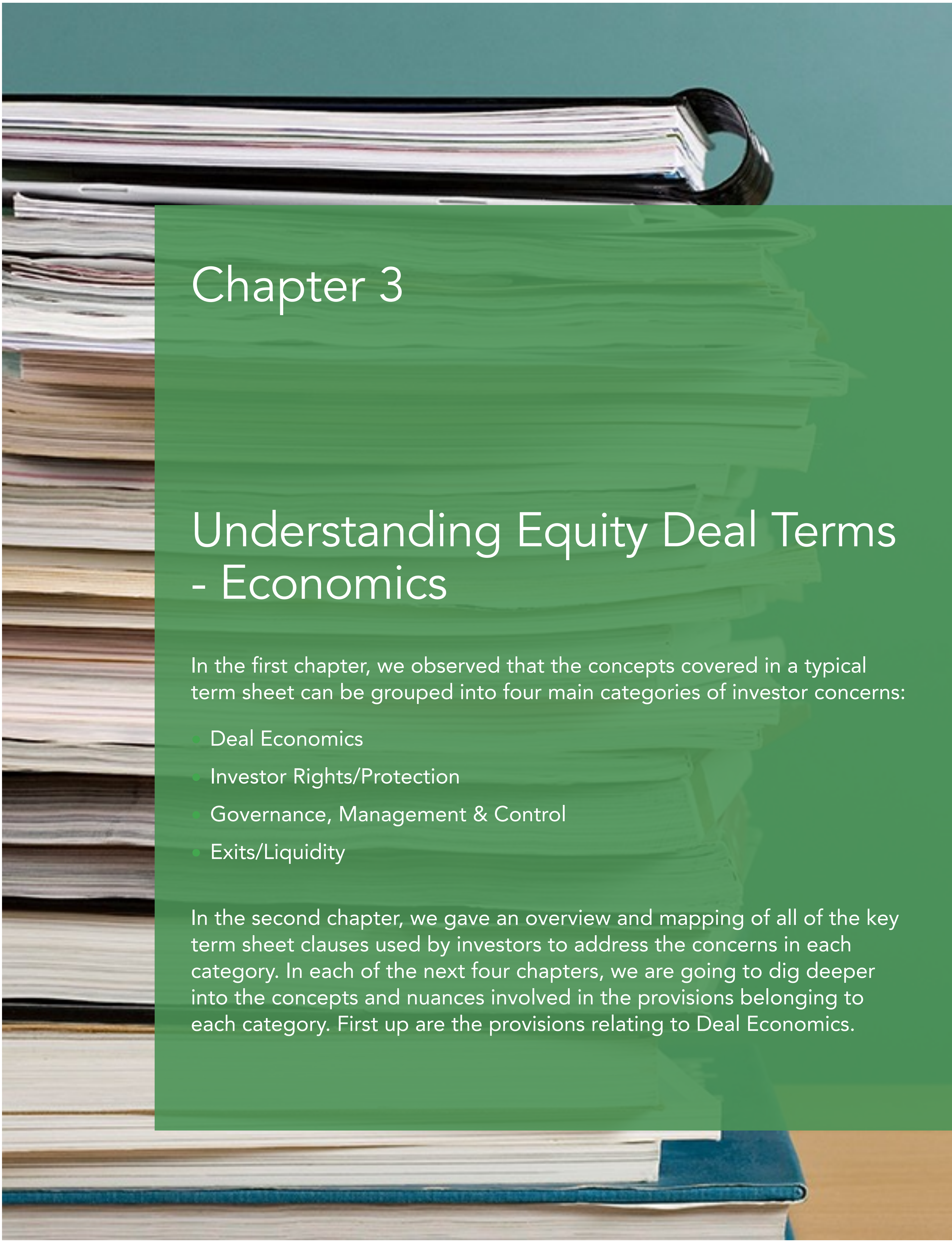
The key provision to accomplish that is the drag-along provision, which states that if the investors want to sell the company, and they are backed by a certain amount of stockholder support, a small minority cannot block the transaction, but must go along with the majority looking to sell.

> **Investors** want to make sure they **maximize** the chances of getting their money back in all possible **exit scenarios** (positive or negative).

This drag-along provision is sometimes accompanied by redemption rights, which allow investors to demand repayment of the money they invested, plus some agreed-upon return, usually during a window of time a few years out from their initial investment. If things are not going well, such a repayment could cause a cash crunch which would have the effect of forcing the company into a sale or recapitalization.

And finally, it is in the exits and liquidity section where you will see registration rights. Registration rights entitle the investors, as part of an IPO, to have their stock registered with the SEC so that they become fully liquid and tradeable after the IPO.

So that concludes a quick initial overview and mapping of the key provisions used in each of the four investor "concern categories." In the following chapters, we will dig deeper into the concepts and nuances involved in each of these provisions.



Chapter 3

Understanding Equity Deal Terms - Economics

In the first chapter, we observed that the concepts covered in a typical term sheet can be grouped into four main categories of investor concerns:

- Deal Economics
- Investor Rights/Protection
- Governance, Management & Control
- Exits/Liquidity

In the second chapter, we gave an overview and mapping of all of the key term sheet clauses used by investors to address the concerns in each category. In each of the next four chapters, we are going to dig deeper into the concepts and nuances involved in the provisions belonging to each category. First up are the provisions relating to Deal Economics.

Round Size

One of the first questions to be tackled is the size of the round (i.e. how much money will be invested.) Here pragmatism rules the day. Since the company's valuation is only going to go up with time and accomplishments, you always want to raise as little money as possible at today's valuation. However, there are three countervailing factors arguing in favor of doing a bigger round:

- It takes time and capital to accomplish milestones that matter,
- The future funding climate is always less certain than the present funding climate, and
- Each fund-raising event costs money and takes a great deal of founder time.

These factors amount to a solid argument for always raising a little bit more than a company thinks it absolutely needs. Things always take longer and cost more than management expects. So smart entrepreneurs and investors generally look at the key near term milestones the company needs to achieve, make a generous cost projection, and then add maybe 25% on top of that. In theory there might be a little extra dilution with this approach, but there are time and transactions savings. Nine times out of ten, the company needs the money anyway!

Valuation

Valuation is a long and therefore separate topic, but suffice it to say, it is one of the most critical aspects of any deal. It is usually set by the market (i.e. by the lead investor based on what she thinks it will take to fill the round), and that analysis is usually guided by a number of different modeling techniques and informed by experience and knowledge of her market. Future articles in this series will talk about valuation in detail.

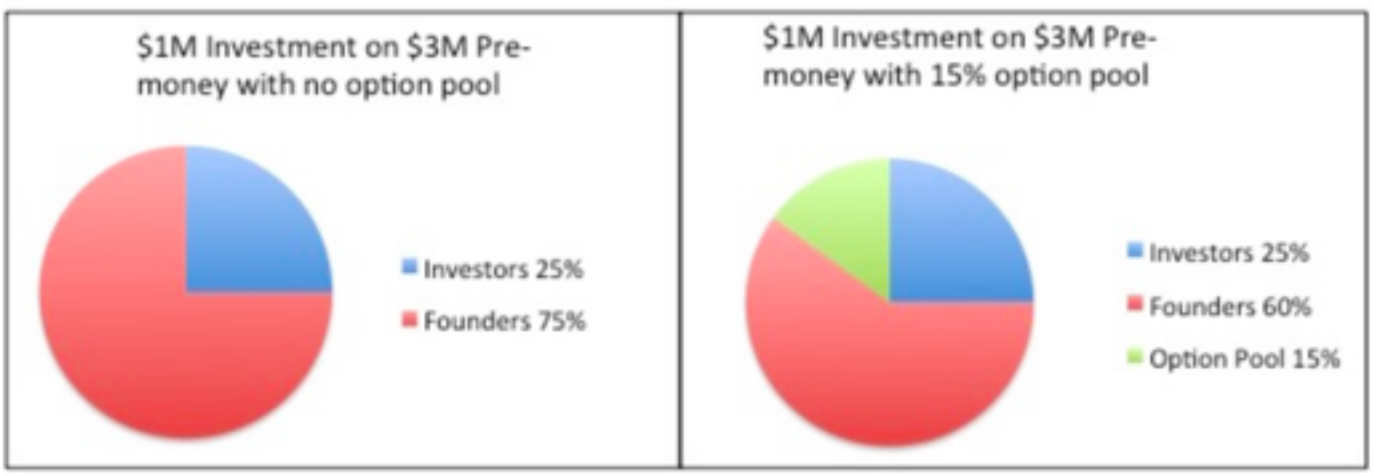
Option Pool Size

New investors are often puzzled by the fact that the size of the option pool is a headline issue right up there with the size of the round and the price. Shouldn't that operational detail be one of the last issues discussed? No, because the size of the option pool is closely linked to the valuation.

Example Termsheet Option Pool Language:

"The total number of pre-money shares to include an unallocated employee pool large enough on a pre-money basis to equal _[10-15]_% of the total fully diluted post-money capitalization, including founders' shares, outstanding warrants and options."

Investors always want the company to establish that pool prior to their investment so that the creation of the pool does not dilute their ownership and raise the effective valuation of the deal. Investors want to invest in a company which has the tools necessary to attract and retain talent (i.e. employee stock options). The bigger the pool, the bigger the tool, so investors want a good sized pool. However, since it is coming out of the pre-investment cap table, the dilutive effect for the founders is similar to a change in price. This simple chart shows a comparison of how post investment founder



ownership changes with the creation of an option pool. They clearly own less of the company, but economically they should be just as well off because the company has a critical tool for growth, so the dilution should be very well spent.

Liquidation Preference

The liquidation preference is a repayment priority associated with the shares on offer. Preferred stockholders are always entitled to repayment before common stockholders, but the liquidation preference provision specifies key details like:

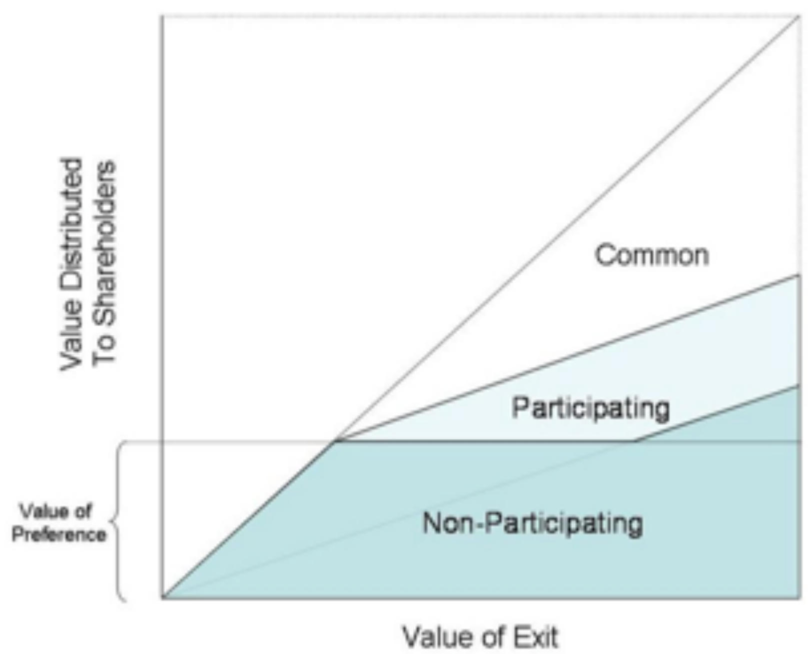
- Whether they are entitled to more than 1X their original money before common stock shareholders get paid, or
- Whether they are entitled to participate with common stock shareholders after they have been paid back their original principal.

Preferred always has the right to convert to common stock. If the per share price in the exit transaction is high enough, they will get a better return by converting than they will by just taking their original money back. But from time to time over the years liquidation preferences in excess of 1X have come briefly into fashion (e.g. the right to be paid 2X or 3X your original money before others are paid). That approach makes the clause into more of an offensive clause (getting a return) than a defensive clause (merely getting your principal back) and introduces financing dynamics that tend to be destructive to the company over time. This is especially true if they occur in an earlier round - all subsequent rounds want terms at least as good as earlier rounds. So, as the offensive liquidation preferences add up, the stack of money due to be paid out before founders mushrooms very quickly. If that stack gets big enough, founders have little prospect of earning a return. That can render the company unfundable because later investors don't want to invest in a company where the founders aren't going to work with all their heart because they have no reasonable expectation of return.

Example Termsheet Liquidation Preference Language (Participating Preferred):

"In the event of a sale, liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows: first, the original purchase price (i.e. 1X) plus declared and unpaid dividends shall be paid on each share of Series Seed Stock. Thereafter, the Series Seed Stock participates with the Common Stock on an as-converted basis. A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event, thereby triggering payment of the liquidation preferences described above unless the holders of a majority of the Series A Preferred elect otherwise."

One compromise in the middle is called participating preferred stock. Holders of participating preferred reserve the right to get their initial principal back first, but then also convert into common and get their share of the pay-out as a common stockholder. The reason it is a middle ground is that it is neither offensive nor defensive. This approach doesn't do much for them in a horrible outcome (where they will be lucky if there is enough to even pay some of their preference), and it doesn't really change the economics much in a grand-slam home run scenario (where the vast majority of returns is a function of the value of the common). What it does is give the holder a modest proportional sliding-scale return in a mediocre outcome. And it does so without the obnoxious, glaring, hard-coded non-linear return they'd get with a liquidation preference of greater than 1X.



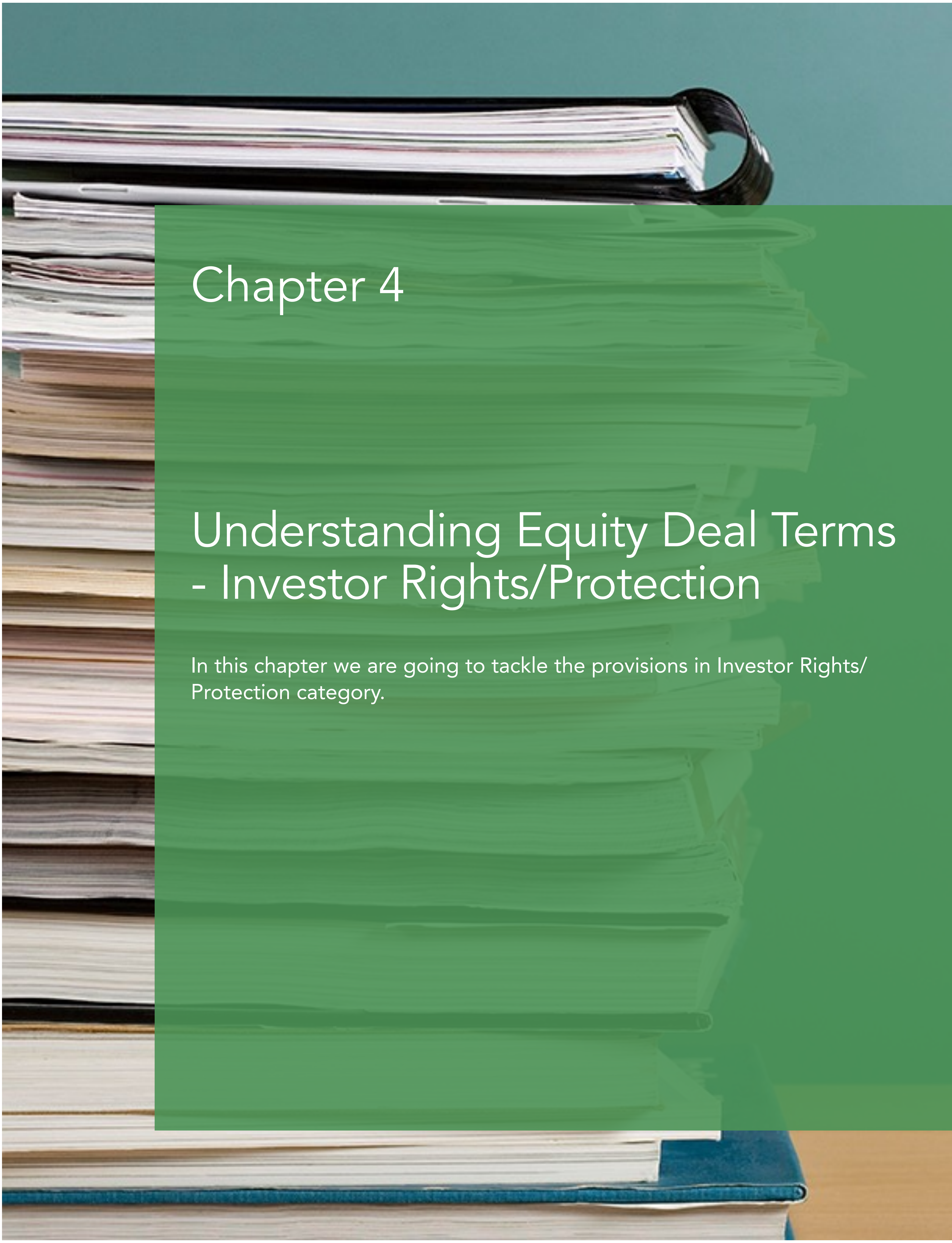
The decision regarding when to take your preference and when to convert can be a tricky one, and it can be tricky to calculate the returns to common until you understand who will convert when. This cascading chain of action-consequence-reaction-consequence is sometimes referred to as a waterfall and a device called a waterfall diagram is sometimes used to graphically depict it. Going into great detail on waterfalls is beyond the scope of this chapter, but for those who are interested, the above diagram from Wikipedia.org is a simple look at a basic waterfall diagram for participating preferred. In it you can see how as exit value rises beyond various thresholds, the value available for distribution to common increases (and the incentive to convert to common kicks in).

Example Termsheet Liquidation Preference Language (Non-Participating Preferred):
"One times the Original Purchase Price plus declared but unpaid dividends on each share of Series Seed, balance of proceeds paid to Common. A merger, reorganization or similar transaction will be treated as a liquidation."

Dividends

It is very unusual for a high growth startup to pay regular cash dividends. The cash would theoretically generate a better return for shareholders if reinvested in growth and share price appreciation. But you do often see accruing dividends, which do not pay cash out in the present, but specify that they are to be paid at some future date, upon certain contingencies, or at the board's discretion. These accruing dividends can specify payment in cash, common stock or preferred stock. Aside from delivering a slightly better overall return for stockholders, these dividends serve a very useful secondary function: they keep a time clock on the entrepreneurs to make sure there is some compensation to investors for the excessive passage of time. The more time has passed, or the earlier you became a stockholder, the more your dividends amount to.

Example Termsheet Dividends Language:
"Series Seed shall be entitled to non cumulative dividends as, when and if declared. Series Seed Stock to participate in all dividends declared on an "as converted" basis. No dividends payable on Common Stock or any other Class of Preferred without payment of similar and all accrued dividends to the Series Seed Stock."



Chapter 4

Understanding Equity Deal Terms - Investor Rights/Protection

In this chapter we are going to tackle the provisions in Investor Rights/ Protection category.

Anti-Dilution

The most important provision in the protection category is the anti-dilution provision. This clause prevents the company from diluting investors by later selling stock to someone else for a lower price than the earlier investor paid. Now, it is true that any issuance of stock is technically going to be dilutive in the simplest sense of the word. This is because it will further divide the pie and lower the original investor's percentage ownership. But it is not that simple; an issuance at a higher price is merely *arithmetic* dilution rather than *economic* dilution. An investor may hold less stock, but (i) that stock has been revalued upwards by the new pricing, and (ii) the company she owns a part of also has more cash on the balance sheet. An issuance at a lower price is the opposite; it is both *economically* and *arithmetically* dilutive.

Enter the anti-dilution clause, which has almost magical properties. This clause says that if a round happens at a lower price, the earlier investors purchase price is automatically and retroactively changed, and her original investment is automatically recalculated to a lower price. In effect, she gets more stock for her original investment.

Example Termsheet Anti-Dilution Language (broad-based):

"Weighted average anti-dilution, calculated as follows: in the event that the Company issues additional securities at a purchase price less than the then-current Series Seed Stock conversion price, such conversion price shall be adjusted in accordance with the following formula:

CP2 = CP1 * (A+B) / (A+C)

Where:

CP2 = Series Seed Conversion Price

CP1 = Series Seed Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding Common Stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)

B = Aggregate consideration received by the Company with respect to the new issue divided by CP1

C = Number of shares of stock issued in the subject transaction."

How much is the price changed? Under the terms of the rare, and unreasonably harsh, full-ratchet anti-dilution clause, all of her stock is fully repriced to the new lower price without any regard to the size (i.e. impact) of the lower-priced offering. Under the terms of the more common and more reasonable "weighted average anti-dilution clause," the size of the other offering relative to the total capitalization of the company is taken into account in the calculation. As a result, the downward adjustment of her price more closely and proportionally reflects the degree to which she was harmed. Sometimes these calculations will be broad-based. This is where the denominator for the calculation takes in every possible aspect of the company's capitalization including the option pool or as-converted common numbers after giving effect to various preferences. Sometimes it is more narrowly based and excludes things like the option pool.

Full-ratchet sounds better for the investor, right? Don't be so sure. Since the economic brunt of anti-dilution clauses are felt by the founders (in the form of reduced ownership percentages), very severe anti-dilution terms can have the effect of nearly completely wiping out the holdings of the founders, thus rendering them absolutely desperate to avoid a down round at any cost. They may resort to taking any inappropriate type of investor they can find. Or if they absolutely cannot avoid a down round, they may no longer be incented to keep working for the company since they will never see a real return. So to fix that, the investors have to grant them options to keep carrying on. The net result is about as much dilution as they would have experienced with a more reasonable clause in the first place, but with a lot more work, and hard feelings, and without the flexibility of a more moderate clause.

Example Termsheet Control Provisions Language:

"So long as at least 10% of shares of the Series Seed Stock sold in this Private Placement are outstanding, in addition to any other vote or approval required under the Company's Certificate of Incorporation or By-laws, the Company will not, without the consent of the holders of at least a majority of the Series Seed Stock, either directly or indirectly by amendment, merger, consolidation, or otherwise."

Control Provisions

The anti-dilution provision is very strong medicine, but it operates automatically, indirectly, and after-the-fact. The other provisions in this category attempt to control founder behavior more directly and proactively. The first is an assertion of the right (by the board, or a class of stock, or that class' director) to approve any change of control or liquidation of the company. These clauses typically require that any merger resulting in an effective change of control of the company, any material acquisition or any liquidation of the company be approved in advance by the shareholders. Because the transaction cannot be done without investor permission, the investors know they will be asked to approve a transaction in advance and can be sure they will not be surprised by a transaction after the fact.

Other control provisions will require approval of:

- Material (i.e. significant) contracts or leases;
- Annual spending budgets and exceptions;
- Changes to the management team;
- Payment of dividends or redemptions of stock;
- Assumption of any debt obligations;
- Changes to the capitalization or authorizations of new classes of stock; or
- Changes to the charter or bylaws.

In each case the idea is investors will be at the table and have a say in any important decisions or any decisions which will affect their economic rights directly.

Pro-Rata Rights

Working in parallel are similar provisions controlling transactions not involving the company itself, but involving the company's stock. The first reserves the right on behalf of investors to participate in any future financings. If things are going well, current investors will have the right to invest more. Sometimes this right is open-ended. Other times each investor's right is capped at their pro-rata ownership in the company to allow them to maintain their percentage ownership, but no more. Thus, this clause is often referred to as "pro-rata rights."

Pro-rata rights can be extremely valuable rights to have in super-hot companies, so they can come with some strong provisos. In response to shenanigans where people try to profit unduly off their pro-rata rights by selling them to outsiders looking to gain access to hot deals that would otherwise be closed off, it is increasingly common to see language to ensure that the holder of pro-rata rights does not try to transfer those rights to third parties directly or indirectly through investment vehicles. Pro-rata rights may also be narrowed by calculating them without including any unexercised options or warrants a stockholder owns. Pro-rata rights for earlier shareholders may also be subject to extinguishment if they are not used each round, or they may simply be negotiated away entirely as a condition of later financing rounds.

Example Termsheet Pro-Rata Rights Language:

"Investors will have a right to maintain their pro rata interest in the Company on a fully diluted basis in any subsequent offering of securities. In any subsequent rounds of financing where the round is limited to major investors, the investments of all members [in this investor group] shall be aggregated together for the purposes of calculating whether group members count as a major investor."

ROFR & Co-Sale Rights

After pro-rata rights to buy more stock issued directly by the company, the second collection of protection rights in this category relates to secondary stock transactions – stock sold by a founder (or major stockholder) rather than by the company itself. This provision pairs two opposing sides of the same coin: a right of first refusal (ROFR) on one side and a co-sale right on the other. Under the terms of these provisions, if a founder or major stockholder is legally permitted to sell any of her stock, first, the investors (or the company) will have a right of first refusal to buy that stock before it can be sold to a third party. These ROFRs also generally say that if the investors don't want the stock, the company has a right to exercise the ROFR and buy it. This allows them to increase their position and keep unknown third parties out.

However, the investors may not want that stock, because things might not be going as well as hoped for the company. So, the investors pair the ROFR with an alternative right on the flip side of the coin: investors reserve the right to sell a proportionate amount of their stock as part of any transaction that the founders are able to arrange. This way the investors are covered if things are going well because they can acquire more stock and prevent new investors coming in. And, they are covered if things are going poorly because they can make sure that nobody gets liquidity before them - they get to sell a proportionate amount of their stock to any buyer who can be found.

Example Termsheet ROFR & Co-Sale Rights Language:

"The Company will have a right of first refusal to purchase a proportional part of shares lawfully offered for sale by founders ("Founders"), management of the Company or other shareholders, if a shareholder wishes to sell stock before an initial public offering. If Investors so choose, Investors shall have the right to sell a proportional part of their holdings along with Founders or other shareholders before an initial public offering."

Chapter 5

Understanding Equity Deal Terms - Governance, Management and Control

In this chapter we are going to tackle the Governance, Management and Control category. Since equity investors have no legal right to be repaid the way a lender does, their only path to repayment is through the success of the company. It is natural for them:

- To want to know what's going on in the company,
- To have a say in critical decisions, and
- To protect against founder behavior that could be damaging to the company.

There are four principal ways investors implement this: board seats, governance provisions, information rights and founder restrictions.

Investor Board Seats

The investors in a given round will typically negotiate to have a representative join the board either as a full, voting board member, or as an observer with no voting rights. In many cases they will ask for both types of seats. The board seat will typically be combined with governance provisions requiring board or committee approval for a list of important operational activities. These provisions will, in some cases, reserve a veto right for the investor board member on key matters. The investor board seat is usually not term-limited. But, the expectation and custom is that as additional investor directors are added through additional larger rounds of financing, and the board grows unwieldy, that some early investor directors may drop down to being observers, or may roll off the board entirely in the belief that it is best for the company. The right to appoint a board seat is usually part of a section which specifies the structure of the entire board.

Director approval rights will often cover the annual budget and any expenditures not in the budget, any borrowing, or any leases or material contracts. Stockholder approval rights will typically require a significant percentage of stockholders (or a percentage of stockholders in one class) to approve any amendments to the company's by-laws or charter in a manner adverse to the interests of preferred stockholders, any increases to the number of authorized shares of preferred stock, the authorization of any stock having equal or better rights, the redemption of any stock or payment of any dividends, or the sale, merger or liquidation of the company.

Example Termsheet Board Composition Language:

"The Board of Directors shall initially consist of five directors and one observer:

• the Chief Executive Officer of the Company, initially [__________]

• a co-founder of the company, initially [_________]

• one investor representative nominated by [lead investor] and acceptable to the holders of a majority of the Series Seed Stock (the "Series Seed Director")

• a second investor representative nominated by the holders of Series Seed and acceptable to [lead investor]

• an independent director nominated by the CEO and acceptable to the Series Seed Director."

Information Rights

Paired with these board provisions are information rights, which place a requirement that the company regularly share with investors information on the company's financial and business condition. Although some CEOs will voluntarily update investors as frequently as once a month, most information rights clauses merely obligate the company to provide quarterly management reports with some financial or management dashboard data and to provide detailed annual financials, within a certain period after closing the fiscal year. With very early stage rounds, these financials are often not required to be audited. Later round investors will typically require audits. Investors also reserve the right to inspect the company's books and records, though this right is afforded them under the law of most states anyway.

Example Termsheet Information Rights Language:

"Series Seed shall have the right to the following information:

- Audited annual financial reports to Investors within 180 days of the end of the fiscal year.
- Monthly unaudited financial summary and "management dashboard" updates on progress and accomplishments against targets in past and next period, in a mutually agreeable form, to Investors by the 15th calendar day of the following month.
- Annual budgets will be supplied to the Board of Directors at a regularly noticed Board meeting, but in no event later than 45 days prior to the beginning of each fiscal year for approval.

Founder Restrictions

To address the risks associated with relying on a small number of key founders to make the company successful, investors will generally insist on a couple important founder-related provisions. The first provision addresses the risk that a key founder will quit her job, leave the company with a huge gap in the team and potentially its know-how, and take a chunk of stock which will dilute the investors and potentially vote against their wishes. To prevent this, investors typically insist on what is called "founder vesting".

The term is actually a misnomer because the stock is already owned by the founder and is therefore not subject to vesting. Instead, these clauses provide for a contractual right on the part of the company to "claw-back" (buy back at a low price) some portion of the founder's stock in the event that she leaves the company in the early critical years. The right may apply to all or merely some of the founder's stock. It is always designed to phase out over time, so that more and more of the stock returns to being unrestricted each quarter or year. (Therefore it is more accurately thought of as lapsing of restrictions than vesting of ownership.)

"Founder vesting" (i) creates a strong financial incentive to remain with the company (ii) avoids a major inequity among the founders who stayed and are working to make their stock valuable (iii) avoids dilution by pulling stock back in, which can be used to pay a hired replacement and (iv) avoids a situation where an angry departed founder controls a large voting block.

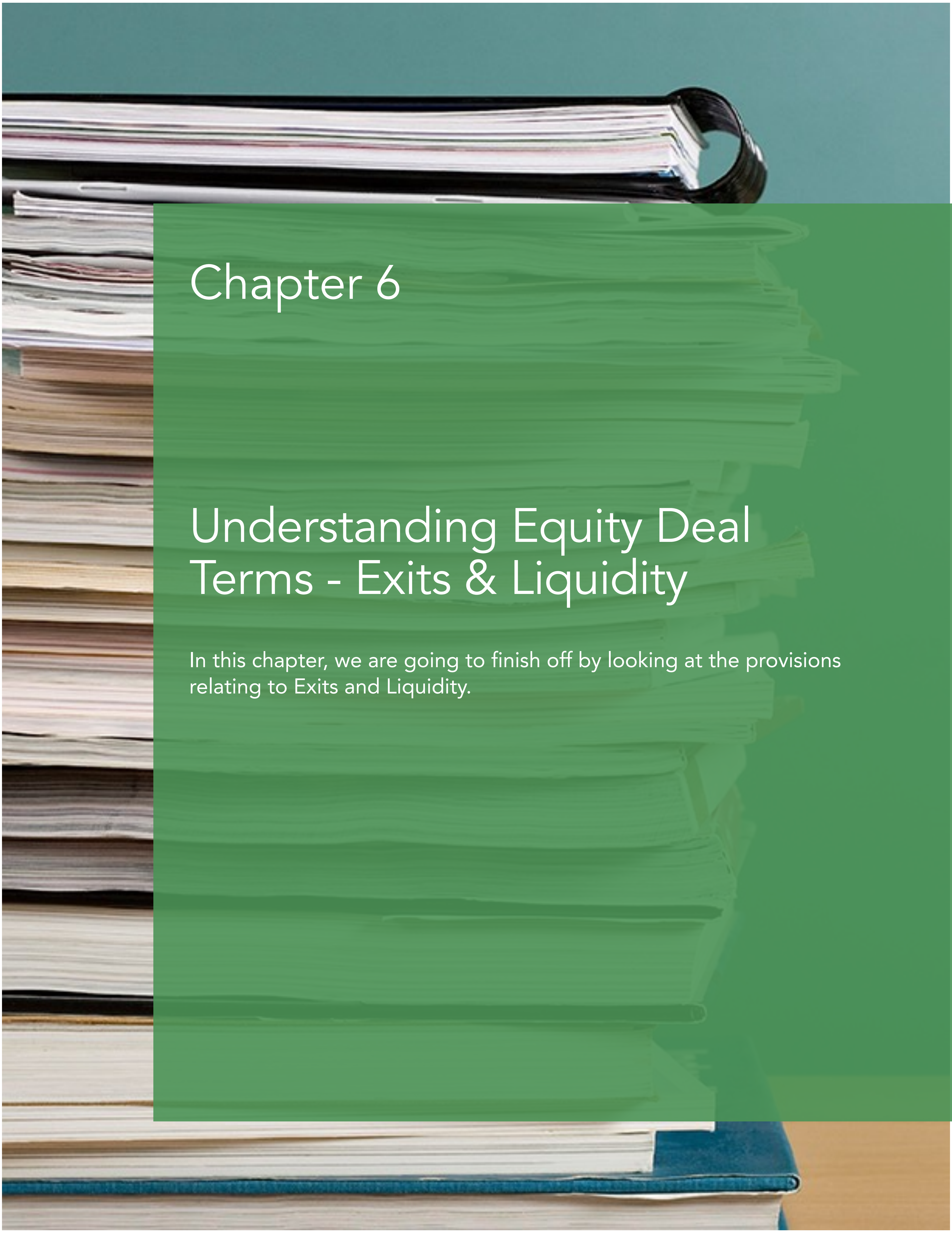
Example Termsheet Founder Vesting Language:

"Common stock owned by any Founder with more than 5% of the outstanding, post-Private Placement equity of the Company will be subject to the right of repurchase by the Company for $0.0001 per share if the Founder's employment with the Company ceases within the first [four] years following the private placement. Such a right expires over [four] years on a monthly basis after the initial closing of the Private Placement ([2.083%] per month for 48 months)."

Investors will almost universally insist on clauses which forbid departed employees from using the company's confidential information for any purpose and from attempting to hire away any of its employees for a period of time following their departure. In jurisdictions where it is allowed, investors will often also require that founders as well as other employees sign agreements not to compete with the company in the event that they depart. And depending on the situation, investors will sometimes purchase one or more "key person insurance" policies to hedge the risk of death or illness of an essential founder or employee.

Example Termsheet Founder Non-Poaching/Non-Compete Language:

"In addition to standard confidentiality/assignment of inventions agreements, Founders and other key employees to execute agreements [not to compete with the Company or] solicit employees of the Company or its subsidiaries, directly or indirectly, for one year after termination of employment."



Chapter 6

Understanding Equity Deal Terms - Exits & Liquidity

In this chapter, we are going to finish off by looking at the provisions relating to Exits and Liquidity.

Drag-Along Rights

Sometimes more euphemistically called "bring-along rights," these clauses serve a very important purpose in marginal exit scenarios. These clauses require that when a transaction amounting to a change of control of the company is proposed, and a majority of the preferred stock and a majority of the common stock are in favor of it, all stockholders have to vote in favor of it. The purpose of this should be pretty obvious: not allowing a minority of stockholders (for example, a sentimental founder, or a more optimistic and aggressive roll-the-dice investor) to block a transaction desired by a majority.

In clear-cut grand-slam scenarios this type of coercion isn't necessary. But how often do those scenarios occur? In most cases, it is much less clear whether the wiser course is to press ahead or whether to throw in the towel and sell. If you allowed group indecision to reign, nothing would ever get decided, and mediocre windows of opportunity would close, typically leaving even worse ones to follow. So even if it leads to results that are less than investors hoped, biasing things with a hair trigger toward liquidity ensures that at least investors don't waffle and end up with nothing. In effect, drag along clauses ensure that investors will make what are sometimes called type 2 errors (failing to invest in something great or in this case, selling too early) rather than the far more painful type 1 error (investing in something worthless, or in this case failing to sell something worthless when you had the chance.)

Example Termsheet Drag-Along Language:

"With respect to any transaction resulting in a "Change in Control" of the Company which transaction is approved by (i) holders of a majority of the Series Seed Stock and (ii) the holders of a majority of the Series Seed Stock and the Common Stock, voting together as a single class, all stockholders will agree to (a) vote all shares to approve such transaction, and (b) execute such other documentation and otherwise participate as is necessary to effectuate the transaction in such transaction. For purposes of these Drag Along Rights, the term "Change in Control" shall mean any sale of all or substantially all of the assets of the Company, or any sale, exchange, merger, conveyance or other disposition of securities of the Company in which more than 50% of the voting power of the Company is transferred."

Registration Rights

Registration rights address what happens with an investor's stock in the event of an IPO. IPOs are a complicated (and expensive) process that accomplish two fundamentally separate things: (i) registering the company itself as a public reporting company under the rules established by the Securities Exchange Act of 1934 and (ii) registering the stock actually being offered to the public under the rules of the Securities Act of 1933 so that the stock is freely tradeable without restriction. All investors who make it to the IPO promised land obviously want their stock to be registered and freely tradeable (so that it is not subject to holding periods and volume limitations), but the greater the number of different blocks of stock that need to be registered, the more complicated and expensive the offering is. This is especially true with secondary shares being offered by investors rather than primary shares being offered directly by the company.

Example Termsheet Registration Rights Language (pragmatic):
"The Company will covenant not to grant Registration Rights to any person or entity unless such rights also include the Series Seed Stock on a pari passu basis."

Back in the good old days (i.e. prior to about 2002), registration rights were a very important part of an early stage investment term sheet. A lot has changed since then; IPOs are a much less common method of exit for a number of reasons. So to most practitioners it seems silly to negotiate rights in a very early round that would only be used many years and many rounds of financing later, if they are even used at all. As a result, if registration rights are even included in an angel term sheet these days, they are watered down to the point of saying "we will get customary piggy-back rights" (i.e. registered secondary stock on top of the primary stock) or "if later preferred stock investors get them, we will get them on the same terms too." Footnote: if the new Reg A+ rules really catch on in a broad way and Reg A+ mini-IPOs become a common phenomenon, some new variation on registration rights might return to being a hotter topic in angel term sheets.

Redemption Rights

Another term you don't see as often in pure angel deals these days is the redemption rights clause. This clause specifies that investors have a right to demand redemption (essentially repurchase) of their stock during a specific window of time. These can be a very important tool for structured VC funds who are on a ten or twelve year time clock. This is because they allow the VC to get their money back and return it to their limited partners during the planned life of the fund. The way they do that in many cases is like a huge time bomb that creates a liquidity crisis for a fast-growing company. Management is forced to either sell the company in a non-optimized way, or stick remaining shareholders with a hasty and sub-optimal financing.

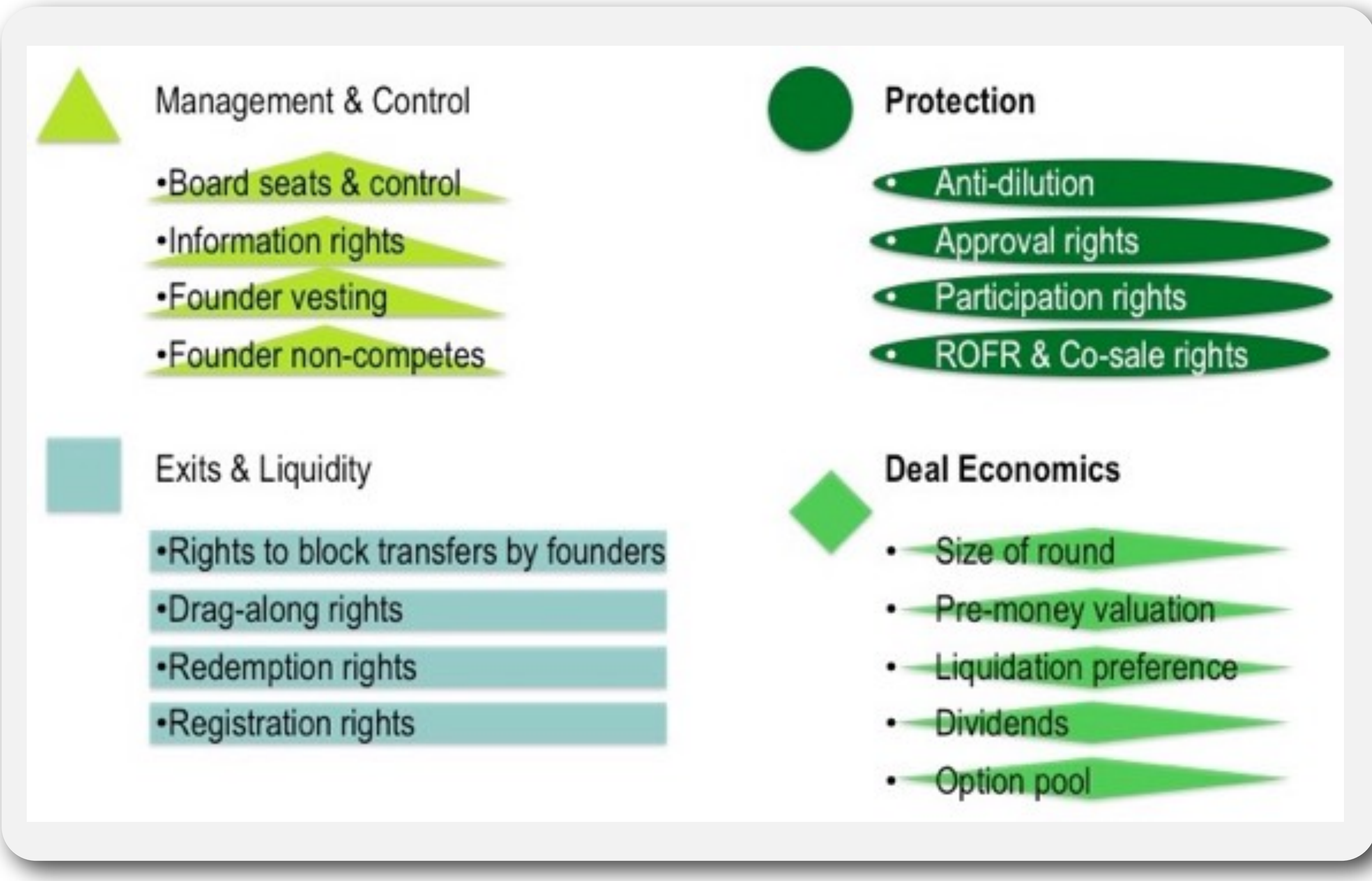
When angels do see these rights, it is usually in hybrid angel/VC rounds and they typically specify that the company will pay the redeeming party the greater of (i) fair market value or (ii) the original purchase price plus an interest rate in the 5-10% range. Redemption rights clauses can be softened in a number of ways; the opening of the window can be conditioned on certain events or set to start five or more years out, they can specify that the company has several years to get the redemption done, or that the company only has to redeem a certain fraction of the stock each year for several years.

Regardless of how they are set up, they are generally a clause that angels want to try and stay away from if they can. They do catalyze actions, but not always good ones, and often to the benefit of some stockholders over others. (For example, stock holders who cannot afford to be as patient as some investors can afford to be.)

Example Termsheet Redemption Rights Language:

"Unless prohibited by the law governing distributions to stockholders, the Series Seed shall be redeemable at the option of holders of at least [50]% of the Series Seed commencing any time after the [fifth] anniversary of the Closing, at a price equal to the Original Purchase Price plus all accrued but unpaid dividends. Redemption shall occur in [three] equal annual portions. Upon a redemption request from the holders of the required percentage of the Series Seed, all Series Seed shares shall be redeemed."

This chapter concludes our discussion on term sheets in which we talked about the main categories of investor concerns, gave an overview and mapping of all of the key term sheet clauses used by investors to address the concerns in each category, and then went back and went through each of the clauses in detail. Next we will zoom out and look at the documents these clauses are built into in order to give a more full sense of how these deals work.



Chapter 7

A Guide To Angel Investing Documents: Preferred Stock Deals

This chapter is intended to provide a quick overview of the principal documents in a fundraising where the investors are purchasing stock. Unlike a convertible debt issuance, these stock transactions permanently alter the capitalization of the company by adding new stockholders, who are typically purchasing a brand new class of stock created for them, typically a series designated class of preferred stock with special rights and privileges they have negotiated.

Given the permanent capitalization changes within a preferred stock deal and the associated complexity of these transactions, there are a great number of different types of deal documents used in stock transactions. For the purposes of clarity, we've divided them into Commonly Used and Occasionally Used. Readers should also keep in mind that this chapter talks in generalities. We will describe where concepts are typically covered in a given set of deal documents. Every deal is different and a given issue may be addressed by counsel in a different way or in a different document in your deal.

Commonly Used Deal Documents in Stock Transactions

Term Sheet

Most deals start with or are accompanied by a term sheet or memorandum of understanding summarizing the terms of the deal. Unless a term sheet expressly states that some or all of its sections are legally binding, early stage investment term sheets generally are not legally binding agreements. Term sheets can be thought of as a set of notes outlining the principal elements of the deal as agreed by the negotiating parties. They serve as a basis for soliciting interest from prospective investors as well as a guide for use by counsel drafting up the definitive binding documents.

Stock Purchase Agreement

The SPA is the core document of any stock transaction. Its purpose is to document and transact the sale and issuance of the actual stock, as well as to specify key terms of the deal and allocate key risks between buyer and seller.

The main sections of an SPA typically include representations and warranties by the company and the founders as to the legal and financial status of the company and its shares, the seller's right to enter into the transaction, and other important factual matters (tightly coupled with the Disclosure Schedules discussed below). There is also a section where buyers of the stock make some representations and warranties back to the seller, and a section where the buyers impose conditions which must be met before they are obligated to buy - this section often reads like a laundry list of the other transaction documents which must be in place simultaneously. And the final section is typically a long "miscellaneous" or "other matters" section containing agreements on how the SPA will be interpreted and enforced, and documentation as to agreements on other legal matters.

Disclosure Schedule (or Schedule of Exceptions)

The disclosure schedules are technically part of the SPA and work in concert with the section on company representation and warranties. Notwithstanding that, the disclosure schedule is worth mentioning separately because (i) it is invariably prepared as a separate parallel document alongside the SPA (and is typically not finalized until the last minute) and (ii) it contains key factual data and reference information about the company which may be useful to you later.

The way disclosure schedules typically work is that the SPA says in SPA section x.x: "the company has no material contracts except as listed in section x.x of the disclosure schedule" or in SPA section y.y "the company has no shares outstanding except those listed in SPA section y.y of the disclosure schedule" or in SPA section z.z "the company is not party to any litigation other than that listed in SPA section z.z of the disclosure schedule." Often when looking for reference information about a company or tracking information for your Seraf account, you can find key bits and pieces in the disclosure schedule.

Investor Rights Agreement (also sometimes Registration Rights Agreement)

The IRA is where certain rights and privileges of the new stockholders are documented. The most common rights in an IRA are (i) the right to have your stock registered with the SEC as part of an IPO, so that they are freely tradable and liquid (typically after a lock-up period of 180 days or so) and note that these registration rights are sometimes handled in a separate Registration Rights Agreement (ii) the right to receive financial and management reports and information from the company and (iii) the right to participate (i.e. purchase stock in) future financings.

IRAs sometimes also contain agreements as to the establishment and composition of board and board committees and the right of the board/ committees to approve corporate budgets and extra-budgetary expenditures. IRAs can spell out the stockholder's rights with respect to dividends and sometimes IRAs contain rules for calculating share price in the event of a dilutive issuance, i.e. anti-dilution protection (though this provision is more typically found in the Certificate of Incorporation) or redemption rights which are the rights to force the company to redeem your shares for cash under certain circumstances. And finally, in some IRAs you will find language about the company's obligation to pay directors expenses and indemnify directors in the event of liability in connection with board service.

Voting Agreement

The Voting Agreement is the document used to ensure that all the signing stockholders vote in concert for the good of all. Sometimes it is just the new stockholders of one class coming in with the new round who sign the voting agreement and sometimes it is all stockholders. A voting agreement typically has provisions requiring signatories to vote to create the board structure agreed upon in the term sheet. They also typically contain what is referred to as a "drag along right" or "change of control drag along" which is the right to make the minority follow (vote for) the "will of the majority," as in approving the merger, acquisition or liquidation of the company. Often voting agreements require stockholders to vote to approve the issuance of all the new common stock necessary to convert preferred shares in the event a conversion is desirable. And typically they contain a provision stating that the stockholder automatically gives a proxy to a designate of the board to vote their shares in the event that they fail to vote them as required.

Right of First Refusal & Co-Sale Agreement

The Right of First Refusal & Co-Sale Agreement (ROFR & CSA) is a clean-up agreement used to document a couple of important rights typically included in term sheets, but not appropriate for the Stock Purchase Agreement. The first of two primary things a ROFR & CSA does is to ensure that no new shareholders are brought into the company without first giving the company the option to buy the shares proposed to be sold (instead of the proposed third party buyer) on the same terms as the proposed buyer.
ROFR & CSAs also typically state that in the event that the company does not want to buy

the shares, that right goes secondarily to the existing shareholders.

The second primary thing a ROFR & CSA does is to ensure that no existing shareholders are able to exit their shares by selling to a third party without giving other shareholders the right to participate in that sale on the same terms and on a pro rata basis.

This may sound odd and contradictory, but think of it like both a floor and a ceiling: the effect of a ROFR & CSA is to ensure that (i) if things are going well with the company, existing shareholders, who took all the early risk, have first dibs on the company's shares and (ii) that if things are not going so great, nobody is allowed to find a buyer and get out unless everyone is allowed to participate in the partial liquidity event on a proportional basis.

The remainder of the ROFR & CSA is housekeeping to ensure that the mechanics of transfer are fair and smooth and any new shareholders are appropriately bound to the terms and conditions of the original shareholders.

Certificate of Incorporation or Certificate of Amendment (Articles of Incorporation in California)

It may seem odd to include a copy of state filing in a deal like this, but the reason this document is included in most early stage equity financings is fairly clever and sensible. Here's why: for most early stage financings, a new class of preferred stock is created, and the preferences or privileges of that class of stock is recorded in the company's Certificate or Articles of Incorporation. These key rights typically include liquidation preferences (getting paid before common stock or other classes of stock), dilution protection in the event of a down round, voting rights, election of directors, dividend rights, and rights relating to conversion into common stock.

What is sensible about that? Two things: (1) State law generally requires the affirmative vote of approval by the holders of a class of shares for a negative change to any of the rights of those shares, so preferred shareholders are going to have legal protection and the right to vote on any changes to their rights and privileges. For example, Delaware law says that the holders of a class must vote to approve any change which: "Increases or decreases the aggregate number of authorized shares of the affected class(es); or Adversely affects the powers, preferences, or special rights of the shares of such class." (2) Because company Certificates of Incorporation are public state filings, anyone considering purchasing the stock of a company has the right to inspect the special privileges given out to the shareholders of preferred stock and know that they are getting themselves into.

Legal Opinion

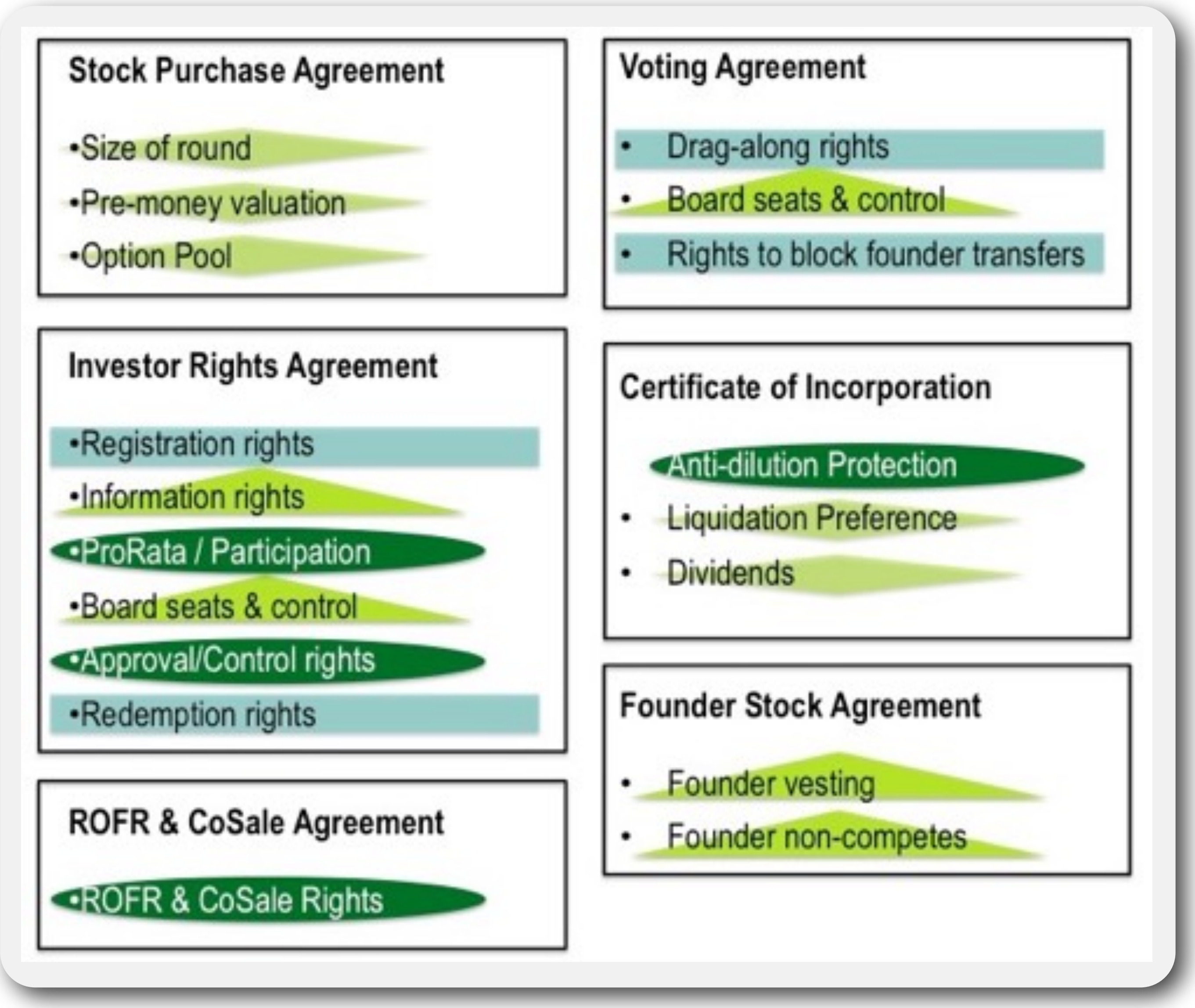
Investors buying stock in a company generally require counsel for the company to stake their reputation "vouching" for the legal status of the company and the validity of the transaction. Legal opinions in this context generally start with a recitation of all of the items counsel has reviewed prior to giving the opinion (deal documents, corporate records) and then go on to say, with varying degrees of wiggle room reserved, (i) that the company is validly existing and in good standing in the state in which it is formed, (ii) that the signing of the transaction documents is legal and accompanied by the necessary approvals and consents, (iii) exactly what the outstanding capitalization of the company is, (iv) that the issuance of the stock is legal under the relevant SEC exemptions, and (v) that there is no material litigation pending. Some things may be added and some of the wording may vary, but these are the basic things investors look for in a legal opinion.

Accredited Investor Questionnaire/ Certification

The vast majority of early stage equity financings are done pursuant to an exemption from the registration and disclosure requirements normally imposed by the US Securities and Exchange Commission on the sale of securities to the public. The scope of the exemption is rather narrow, and among other things, it requires that shares in exempt deals be sold only to accredited investors who are presumed to be sophisticated enough to evaluate a deal without public disclosure and wealthy enough to withstand a total loss stemming from an exempt deal. The accredited investor questionnaire is the document which investors fill out and sign to certify that they are accredited investors eligible to participate in an exempt offering. This questionnaire is not always a separate document - its concepts and certification are sometimes incorporated in the Stock Purchase Agreement or other deal document instead.

Signature Pages

Technically these are not a separate document in any sense of the word - typically this term merely refers to a separate electronic or paper file containing all the signature pages of all the deal documents collected together in one single document for the convenience of a signing party. Once signed, they are attached on your behalf to the relevant documents, counter-signed by the company and returned to you as part of the final closing documents package or "closing binder." Sometimes when looking for key numerical information about your shareholdings or other tracking information for your Seraf account, you can find key bits right next to your signature in the signature pages.



Occasionally Used Deal Documents in Stock Transactions

This section covers documents which turn up from time to time. It is not a problem or concern if they are not used in a given deal; it may just mean: (i) the issues to which they relate are covered in other agreements (ii) the issues to which they relate are not present or relevant in this particular deal or (iii) the lawyers drafting the deal documents have a different drafting style.

Capitalization Table

Early stage equity financings will often, but not always, include a detailed chart or table laying out all of the ownership positions of the different stockholders of the company including common stockholders, preferred stockholders and option and warrant holders (technically these last two are security holders not stockholders.) The capitalization table may either document the various positions before the close of the new round, after the close, or preferably both in one document. Often the Capitalization Table, or at least a high level summary of it, will be included in the Disclosure Schedule (above), but sometimes it is distributed as a stand-alone document. Often when looking for key numerical information about your shareholdings or other tracking information for your Seraf account, you can find key bits in the capitalization table. Capitalization tables often prove useful down the road (for example, when trying to double-check proper payouts in an exit), so it is not a bad idea to ask for a copy of the current cap table every time you invest in a company or sign deal documents. Then just upload them to Seraf with the round and you will always have them for reference.

Board Consent

A company must have the approval of its board to be authorized to partake in an equity financing. This approval is typically recorded in board minutes of a live meeting but sometimes permission is sought and recorded in writing by means of a unanimous written consent; in those cases, a copy of that written consent is sometimes included in the deal document package.

Stockholder Consent & Waiver

Similar to the board consent, under the Certificate of Incorporation or bylaws of a company an equity financing can require shareholder approval as well as board approval, so a stockholder consent is often included as part of the deal. Sometimes it is part of one of the principal deal documents, and sometimes it is a stand-alone document. If the rights of shareholders are being changed or cut back by the terms of the new deal, an explicit waiver of the abridged rights may be included to make it abundantly clear that everyone is onboard with the deal.

Irrevocable Proxy

In a typical equity deal, voting matters are left to the individual shareholders. The assumption is that it is relatively easy for a major investor to put together a majority block in favor of a proposal the major investor would like to see passed. Or a voting agreement is used. But in some deals, nothing is left to chance and investors are asked to assign their voting rights to an investor delegate (this assignment is called giving a proxy to a proxy holder) who can then vote the rights. This is a way of ensuring that shares get voted, blocks get neatly formed and no one has to spend effort or incur delay chasing votes for desirable outcomes. These proxy assignments are generally permanent and irreversible (hence the name irrevocable) transfers of voting rights, so if you see one in a deal package, read it carefully and make sure you are comfortable that the proxyholder's interests fully align with yours.

Indemnification Agreement

Although companies generally carry Directors' and Officers' insurance to protect directors from the damages and expenses of shareholder lawsuits alleging that they did something wrong as a director, many highly skilled and sought-after directors want additional protection if they are going to be convinced to serve. What companies do in that situation is offer to, in effect, re-insure the directors by indemnifying them (agreeing to reimburse them or "hold them harmless") for any expenses or damages they incur while doing their job competently and in good faith. The way this is recorded is in an indemnification clause in one of the principal deal documents, or as a stand-alone indemnification agreement. They are long and jargon-laden documents, but what they basically say is that if the director is doing a good job and acting in good faith, and they get sued by shareholders, the company will make them whole. There are a lot of details about the precise conditions in which such reimbursement will occur and the limits on that reimbursement, but if you see one of these, the concept is pretty simple - the company will cover the directors' costs.

Secretary's Certificate

The Secretary's Certificate is essentially a small cover sheet attesting to the authenticity and accuracy of the copies of the various deal approvals and governance documents. They are typically worded as a series of paragraphs each starting out with "attached is a true and correct copy of the…" and going on to list the bylaws, the board and stockholder resolutions approving the transaction, the names and titles of the current list of officers of the company and the certificates of good standing and legal existence from the state of incorporation. And they are signed by the secretary of the corporation (who may even be the CEO in small companies.)

Compliance Certificate

The compliance certificate is a belt-and-suspenders document intended to give investors extra protection by requiring the company's CEO to personally take responsibility for the transaction. Compliance certificates typically include statements that (i) all the representations and warranties the company has made in the deal documents are true, (ii) that the company has obtained all the consents, approvals, permits and waivers it needed to obtain, (iii) the shares being issued are duly authorized, and (iv) newly revised Certificate of Incorporation has been filed and is in effect. And they conclude with a simple signature from the CEO.

Joinder Agreement

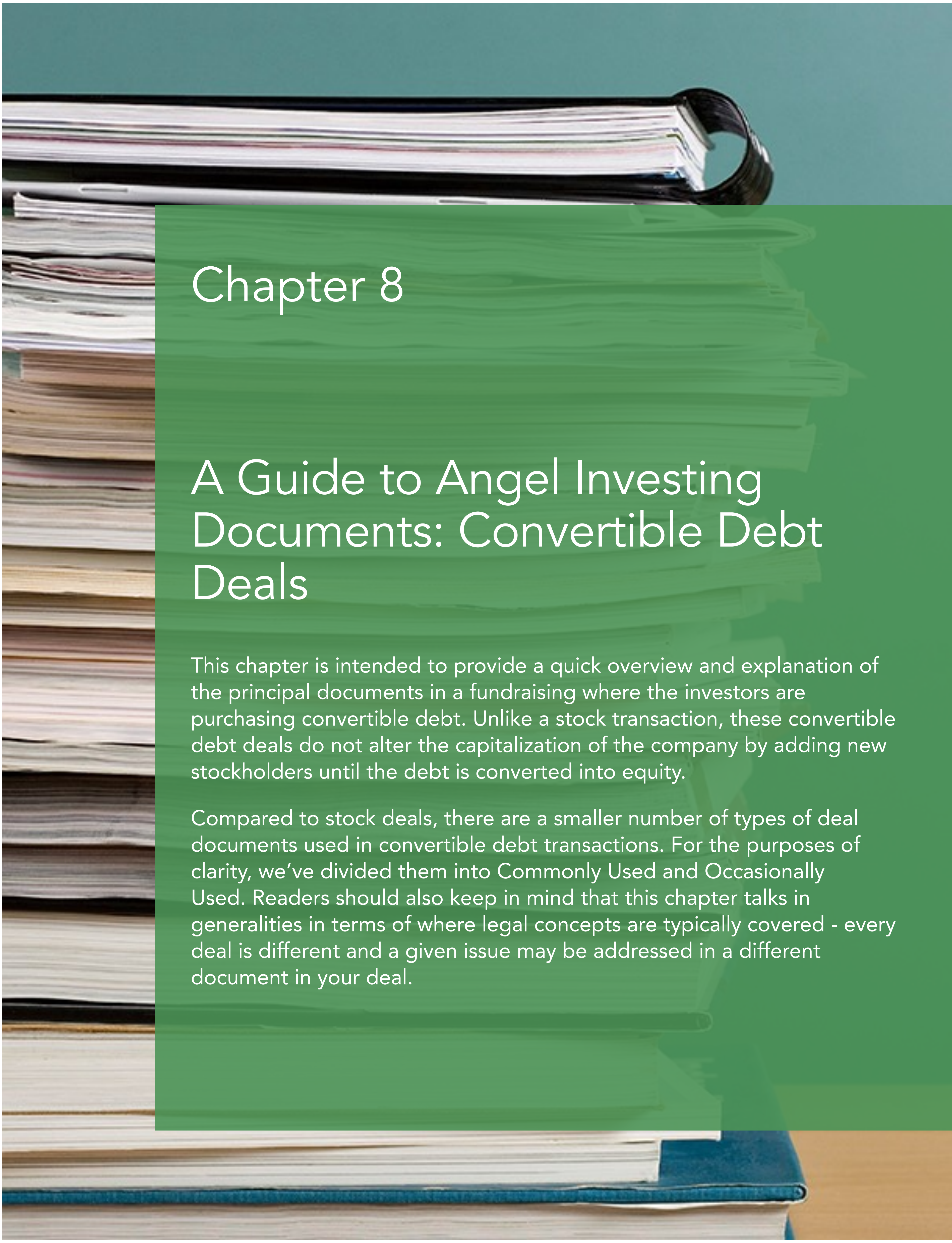
Joinder agreements are sometimes used as an easy way to make new investors a party to existing agreements - they literally join you in with the other signatories. They typically list the specific agreements and their dates and make it clear that by signing the joinder agreement, the new investor is signing, and means to be bound by all the other agreements listed.

Founder Stock Agreement (aka Vesting Agreement or Restricted Share Agreement)

Term sheets in early-stage equity deals often require that the founders' stock be subject to forfeit in the event they leave the company. This concept is sometimes inaccurately nicknamed "founder vesting" but in fact what going on is that founders are agreeing to put a layer of contractual claw-back on top of stock they already own. Given this, "restrictions lapsing" is technically more correct language than "stock vesting," but the economics are equivalent. The claw-backs amount to an agreement that they will forfeit the stock (at a typically very low price so as to not cause a cash crunch for the company) if they leave. The vesting nickname stems from the fact that these restrictions lapse as time goes by. These arrangements are usually documented in agreements variously named things like Founder Stock Agreement or Vesting Agreement or Restricted Share Agreement. Investors are typically not a party to these, but a copy is sometimes furnished to them as proof of their existence because of the importance of the issue.

Risk Factors Statement

A list of risk factors is sometimes furnished to the investors as a way of limiting various types of liability for the company in the event that things do not go as planned or shareholders become unhappy. They literally serve as a "can't say we didn't warn you" device and work by disclosing a variety of risks associated with the investment. Example risks you might see include: the stock being offered is not registered and not liquid, the terms of your deal might be renegotiated in a later financing, the company has a limited operating history and may not be successful, the company has limited operating capital and might run out of money and either fail or need to raise more money on less attractive terms, competitors may out-compete the company, customers may not like the product, the company may not get sufficient intellectual property protection, the company may not be able to attract and retain enough good talent, etc. At most you will be required to acknowledge that you got your copy.



Chapter 8

A Guide to Angel Investing Documents: Convertible Debt Deals

This chapter is intended to provide a quick overview and explanation of the principal documents in a fundraising where the investors are purchasing convertible debt. Unlike a stock transaction, these convertible debt deals do not alter the capitalization of the company by adding new stockholders until the debt is converted into equity.

Compared to stock deals, there are a smaller number of types of deal documents used in convertible debt transactions. For the purposes of clarity, we've divided them into Commonly Used and Occasionally Used. Readers should also keep in mind that this chapter talks in generalities in terms of where legal concepts are typically covered - every deal is different and a given issue may be addressed in a different document in your deal.

Commonly Used Deal Documents in Convertible Debt Deals

Promissory Note

The Promissory Note (or Convertible Promissory Note) is the actual debt instrument in the deal. In reality it is nothing more than a fancy I.O.U. It states the names of the lender and borrower, the date of the debt, the amount of indebtedness, the interest rate, the interest rate calculation mechanism (annual, semi-annual, cumulative, non-cumulative) and the maturity date (due date). Then, usually immediately after those terms there will be some discussion of any negotiated cap on the conversion price or discount against the conversion price if the deal features a cap or discount.

The rest of the note is typically dedicated to setting out the mechanics of converting the debt repayment into stock. In this section you will find language outlining what constitutes a qualified financing - a note-holder does not want stock in a company that is underfunded (she would rather have a cash repayment), so the concept here is to say that "it needs to be part of a pretty robust financing if you are going to convert me into stock." There is also typically some language about what happens if there is no qualified financing before the maturity date. And the final few paragraphs are the usual legal housekeeping clauses about contractual interpretation and enforcement.

Special Terms: Subordination, Security Interests and Guarantees - Occasionally notes will incorporate the concept of subordination, security interests or guarantees. These features are more typical of classic bank type debt, and less common in investor convertible debt, but they are worth mentioning because they do show up occasionally.

- **Subordination** is a legal concept where a lender agrees that its right to receive repayment is subordinate to (i.e. in a lower position or in second priority to) another lender's right to repayment. For example, most banks who have lent to a company will immediately recall their loan if the company tries to borrow from investors unless investors agree their debt is subordinate to the bank's debt.

- **Security Interests** are legal rights allowing the lender to more easily seize collateral in the event of a default on the loan. A note that includes a security interest is called a secured note. These security interests require additional public record state filings to perfect and they are typically signaled in the title of the instrument (e.g. Convertible Secured Note) or right near the beginning of the text.

- **Guarantees** are personal undertakings by someone involved in a corporation to repay the corporation's debt if the corporation fails or defaults on the debt. Banks typically insist on personal guarantees from CEOs before lending, and they may take a security interest in the CEO's home or some other major asset as collateral. Personal guarantees are not common with straight investor debt and probably best avoided - either you believe enough in the CEO and the concept to invest and assume the risk of failure, or you don't.

Occasionally Used Deal Documents in Convertible Debt Deals

Note Purchase Agreement

A Note Purchase Agreement (sometimes called a Subscription Agreement - see below) is a contractual wrapper that makes a note financing a little bit more formal and a little bit more like a stock financing. It typically outlines the mechanics of the closing (to make sure no individual note holders get caught out as the only ones investing), it adds in some representations and warranties on the part of the company around validity and authorization, it add some note holders reps and warranties around eligibility as an accredited investor, and in some rare cases, it may serve to cover some of the key provisions you might expect to see in a Note Holders Agreement or a Voting Agreement (both discussed below.)

Subscription Agreement

A note Subscription Agreement is very similar to a Note Purchase Agreement (above) - mostly it is just a naming convention. Occasionally, however, you will see subscription agreements used to take some of the more complex terms of a note out of the note itself and into a separate subscription contract such that the note and the subscription agreement work as two halves of one convertible debt deal. The effect of doing it this way is the same, it just allows for a more simple note and a more thorough treatment of conversion mechanics in a more traditional contract format.

Note Holders Agreements and Voting Agreements

Sometimes the holders of a note will wisely insist on things like board seats, information rights, covenants against issuing stock or other debt and/or other terms more typically associated with stock deals. When this happens, these contractual agreements between the company and the noteholders are usually written up in a separate agreement given a title like Note Holders' Agreement or Voting Agreement.

Subordination Agreement

Sometimes subordination of debt (see above) is done by means of a stand-alone agreement. This most often occurs when new debt is added after the debt to be subordinated is already in place - for example when there is an outstanding convertible debt round and a revolving line of credit from a bank is added, and the parties enter into a new agreement to make it clear that the old debt is subordinate to the new debt.

Warrant to Purchase Stock

One of the complaints about convertible notes in the early stage context is that they amount to equity risk for debt returns. This results in pricing incentives that lead to a misalignment of interests between company management and the investors. People try to address this with the terms of the note - for example caps on the conversion price and discounts on the conversion price. But these mechanisms do not fully align the interests of the founders and the note holders, so in an effort to better address that, sometimes warrants to purchase shares are given in lieu of or in addition to caps and discounts. It obviously makes the note perform economically more like equity since warrants literally are securities derived from equity, but warrants do introduce a bit of complexity into what is supposed to be a simple transaction.

This concludes our overview of deal concepts and deal documents.

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