Series Compilation: The Anatomy of A Term Sheet 101

Brian Laung Aoaeh

Note: This compilation comprises a series of blog posts that were published at Tekedia between July 2013 and August 2014.

About The Author

Brian Laung Aoaeh is an early stage investment analyst, and a partner at KEC Ventures where devotes the majority of his time to assessing potential early stage technology venture capital investments. Before KEC Ventures, he worked at KEC Holdings – parent company of KEC Ventures, Lehman Brothers, UBS AG and Watson Wyatt Worldwide. He is currently based in New York City.

He holds a BA with a double major in Mathematics and Physics from Connecticut College and an MBA from New York University's Leonard N. Stern School of Business. He is presently a participant in the CFA Program.

He is an unpaid columnist for Tekedia, where he writes about startups, investing and entrepreneurship with a focus on the challenges encountered by African startups.

Brian devotes some of his personal time to volunteer activities related to entrepreneurship and economic development in Africa; with prior affiliations to The Meltwater Entrepreneurial School of Technology (MEST) in Accra, Ghana and The Kumasi Center for Lifelong Learning (KCLL) in Kumasi, Ghana.

Before his departure for the United States he obtained his primary education at the Bayero University Staff Primary School in Kano, Nigeria. He then studied for the WAEC GCE Ordinary Level at St. Francis Xavier Junior Seminary, in Wa, Ghana and for the WAEC GCE Advanced Level at the Presbyterian Boys' Secondary School in Accra, Ghana.

Brian is a devoted husband and father. He is an ardent supporter of the Super Eagles of Nigeria and the Black Stars of Ghana. In his free time he is a fitness enthusiast, and now has several half-marathons under his belt. He has an obsession with cool mechanical pencils. He never says no to a cup of coffee.

He maintains a personal blog at www.innovationfootprints.com and can be found on Twitter; @brianlaungaoaeh.

The Anatomy of A Term Sheet: What is A Term Sheet?[i]

Author: Brian Laung Aoaeh

Congratulations!

As a result of all your hard work investors have become increasingly enthusiastic about your startup. They can't wait to invest. They are eager to discuss the basic terms that would govern their investment in the startup.

There's just one problem. You do not have the foggiest notion about term sheets. This will be your first encounter with one. Don't worry. Over the coming weeks, we'll delve into the anatomy of a term sheet.

Our discussion will attempt to explain term sheet concepts, and describe possible underlying motivations of the counterparties involved in the negotiation. Where it is possible I'll offer some pointers that you might be able to use in actual negotiations.

So, what is a term sheet?

A term sheet is a formal outline of the broad parameters under which an investor might invest in a startup.

It is important to remember this: a signed term sheet does not guarantee that an investment will in fact materialize. The existence of a signed term sheet merely signals the beginning of intense negotiations, and the possible conclusion of deeper due diligence by the investor. The added due diligence could lead your potential investors to become disillusioned, and hence change their mind about the merits of an investment in your startup. If that does not happen, negotiations could hit an impasse on one or more terms.

In any event, the startup and its investors need to negotiate and agree on five documents that will cover the transaction. The transaction is only successfully concluded once the startup and its investors have signed these five documents. The five documents are:

- Stock purchase agreement
- Investor rights agreement
- Certificate of incorporation
- Rights of first refusal (ROFR) and co-sale agreement
- Voting rights agreement

With the exception of two terms, the term sheet is not legally binding on either the startup or the investor. The only binding terms of a term sheet are those that require confidentiality and exclusivity, that is the specific details of the term sheet have to be kept confidential, and the startup may have to agree not to speak with other potential investors for a specified period – 90 days, for example.

In any case, don't let me dampen your spirits. While there's still a long way to go, getting a term sheet suggests that you have come a long way. It should serve as a milestone worth celebrating.

Let's talk again in two weeks.

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[i] Any mistakes in quoting from my sources are entirely mine.

The Anatomy of A Term Sheet: What is A Term Sheet? – Part II[i]

Author: Brian Laung Aoaeh

Last week we started discussing the Term Sheet, a document that lays out the basic parameters that govern a venture capitalist's intention to negotiate an investment in your startup.

Today we'll spend some time briefly discussing some of the items that you will find on your term sheet.

The term sheet will list a closing date, the lead investor – the investor that does the hard work of negotiating the term sheet and also often the biggest investor, and the amount of financing that is being raised from all the investors in the round.

Then the term sheet will outline the economic/financial terms. These are:

- Type of security – this is the type of security that your investors will be getting in exchange for their investment.
- The price per share – this is the price at which new investors are buying into your startup.
- The option pool – stock options that your startup sets aside for employees.
- The pre-money valuation – this is precisely what it sounds like; the value of your startup before the investors' money comes in.
- The post-money valuation – this is precisely what you think; the value of your startup after investors' money has come in.
- All this leads to a change in the capitalization of your startup – so the capitalization table will change to reflect the change in ownership structure of your startup as a result of the new investment.

It is typical for investors to get a security that is different from that held by founders and employees. Founders and employees typically hold common stock while investors typically hold some form of preferred stock. Investors have the right, but not the obligation to convert their preferred shares into common stock under certain circumstances.

Valuation is among the trickiest points of negotiation. Your startup probably has no real track record to speak of. If it did, it would be a company and we could value it using some widely accepted valuation model. Valuation is a much murkier proposition for early stage startups. We'll leave that topic for another conversation.

Your investors will expect you to have accounted for an employee option pool in your pre-money valuation. It is not uncommon for US venture capitalists to seek the creation of a 15% option pool, under the assumption that something in the neighborhood of 10% of that pool will be required to attract management level employees for the startup. The remaining portion of the option pool is set-aside for other team members. Accounting for the option pool in the pre-money valuation ensures that the new investors do not suffer any dilution upon closing their investment.

That capitalization table shows the ownership structure of your startup. In this case it will show a pre-financing cap structure, and a post-financing cap structure. Typically, with each financing round in which new investors buy into your startup, each existing investor will experience a reduction in ownership percentage. The cap table shows each investor's name, the type of security that the investor holds, the amount of capital that that investor has paid into your startup, and the corresponding ownership percentage of your startup that is owned by the investor. The capitalization table can seem deceptively simple to calculate. Don't let your self get fooled. Once you throw in all the other terms that might get

negotiated, a cap table can become a monumental pain in the backside to compute. But it is an important document – it is a record of who owns what in your startup.

The price per share is determined on the basis of the fully diluted pre-money valuation that you negotiate with the new investors.

Seed stage financing term sheets are invariably simpler than series A and series B term sheets. I will focus mainly on the term sheets that govern seed investments. We can tackle the more complex term sheets later on.

Let's talk again in two weeks.

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[i] Any mistakes in quoting from my sources are entirely mine.

The Anatomy of A Term Sheet: What is A Term Sheet? – Part III[i]

Author: Brian Laung Aoaeh

We started discussing term sheets about 4 weeks ago. If you missed that discussion you should consider reading the previous two posts before you read this one.

As I promised last time, we will focus on the terms that typically govern seed investments by early stage angel investors or seed stage venture capitalists.

For this discussion I will use the term sheet that has been made freely available at Series Seed in an effort to standardize and simplify the term sheets that startups and venture investors use to guide the investment process[ii]. Today, I will simply list the items listed under offering terms, over the next few weeks we'll delve into each term in some detail.

Offering Terms

1. Securities to issue – the type of security investors will be issued in exchange for their investment.
2. Aggregate proceeds – the total amount your startup is planning to raise, for example, $1,000,000 in aggregate.
3. Purchasers – under US law the investors have to be accredited investors. This may not apply in other countries, but it matters if you are raising capital from US investors.
4. Price per share – we discussed this in the previous post. More later.
5. Liquidation preference – this is an important term. More later.
6. Conversion – can investors convert their shares into common shares?
7. Voting rights - how do investors vote, and how are their votes counted?
8. Documentation – what other documents will be prepared as part of this transaction? Will there be anything out of the ordinary? Why?
9. Financial Information – who has a right to request financial information from management? What other rights do investors get?
10. Participation – what happens if the startup raises a subsequent round of financing?
11. Board of directors – how will the board be structured?
12. Expenses – how will legal expenses related to this financing be covered? Does the startup pay a portion of the expenses? Do investors pay their own legal expenses?
13. Future rights – what happens to the rights of this cohort of investors when the startup raises capital from a new group of investors?
14. Key holder matters – vesting, IP assignments, non-compete agreements, non-disparagement agreements etc. etc. with key employees of the startup, including founders and co-founders.
15. Binding terms – as we have already discussed, the term sheet is not binding, but certain clauses are.

That's it. Those are the terms. Don't be deceived. There's a lot to consider under each of these. So enjoy the brevity of this week's post. The next post in this series will be considerably longer.

Let's talk again in two weeks.

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[ii] The Series Seed Documents are made available as open source documents through collaboration between Ted Wang, a partner at Fenwick & West, and the folks at Andreessen Horowitz. You can find the Series Seed Term Sheet here.

The Anatomy of A Term Sheet: Securities Issued, Aggregate Proceeds and Purchasers[i]

Author: Brian Laung Aoaeh

We started discussing term sheets about 6 weeks ago. If you missed those discussions you should consider reading the previous three posts before you read this one.

Today we will focus our attention on the first 3 items from the Series Seed term sheet[ii].

1. Securities to issue: Venture capitalists in the United States typically negotiate for some form of preferred stock with two characteristic features;
    - First, it has a variety of preferences over common stock, where common stock is the basic equity interest in a company. In corporate finance common stock sits at the very bottom of the capital structure. Holders of common stock are considered the most junior participants in the capital structure of a company, and they get paid last in the event that the company is sold or liquidated. In private companies employees and founders hold common stock. In public companies investors who purchase their stock through the public markets also hold common stock. The most important preference that preferred shares have over common stock is the Liquidation Preference. We will discuss that in more detail later.
    - Second, the preferred stock is typically convertible into common stock at the option of the holder. In some cases the company may have the right to force conversion, for example if the company wants to sell shares to the public in an IPO. Although I am sure they exist, I have not yet seen a deal in which the conversion multiple is greater than 1 after dividends due the holders of preferred shares have been taken into account.
2. Aggregate proceeds – the total amount your startup is planning to raise, for example, $1,000,000 in aggregate. There are a few issues to consider regarding this topic.
    - Before you start speaking with investors you should have developed an estimate of how much time you will need in order to reach your startup's next significant milestone, at which point you might consider going out to raise another round of capital. You need enough money to last you from the end of this round till you complete the next round of fundraising. I have learned two things as I have observed entrepreneurs raise funds for their startups in the recent past; first it always takes a lot longer to raise funds than you might expect at the outset, second you will need more money and more time to reach that milestone that will signal the start of the next round of fundraising efforts.
    - Don't make the mistake of underestimating either of those two things. Naturally, certain startups will have an easier time in general than their peers. For example, a software only startup will generally have an easier time than a software-enabled hardware startup.
    - It is important to get a very good grasp of what your burn rate will be between successful completion of this round and the completion of the next financing round. Your burn-rate is simply the sum of your monthly expenses. If you have a burn-rate of $15,000 then a $300,000 raise should last you about 20 months if you do not start generating revenues during that period.
    - How much you raise, and the percentage of your startup investors get in return is directly tied to your post-money valuation. We'll discuss valuation later.
3. Purchasers – under US law the investors have to be accredited investors. This may not apply in other countries, but it matters if you are raising capital from US investors. Here too there are a few issues to consider.
    - It is common for investors to invest as a group; to form a syndicate. I like this approach. In the best syndicates, each member brings a unique quality to bear that will be helpful to the startup in the future. For example, one member might have useful industry experience. Another might have strategic expertise across several industries and startup stages. Another might have deep

relationships that will prove to be invaluable as the startup seeks partnerships with larger, better-established companies.

- Wealthy individuals might participate as angel investors. Angel investors come in many different sizes and flavors – as do venture capitalists. So it is important to spend some time thinking about the kind of investor you need before you enter into any contractual relationship. The right angel can really help your startup in its formative stages.
- Venture capitalists come in different flavors. Before you choose which venture capitalists to work with you should do some homework to find out what other entrepreneurs who have had them as investors have to say about them. Some venture capitalists are stage-specialists, for example a seed-stage specialist will invest very early, but will usually not follow-on when you go out to raise a series A round. It is important to understand what that means for you. Sometimes the seed venture capitalist might have very strong relationships with larger venture capitalists that do not invest in seed stage startups. If this is true, then the seed manager might be expected to introduce its most promising startups to that network at the appropriate time. In this case, it is important to know what kind of reputation your seed stage venture capitalist has within the industry.
- Some large venture capital funds have begun to create satellite funds that focus on seed-stage investments as a pipeline for the larger funds. It is a smart strategy to have at least one such fund, one with significant dry-powder for follow-on rounds, in your seed syndicate. If all goes well it could make raising your series A much easier.

Let’s talk again in two weeks.

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The Anatomy of A Term Sheet: Price[i]

Author: Brian Laung Aoaeh

We started discussing term sheets about 8 weeks ago. If you missed those discussions you should consider reading the previous 4 posts I have written for Tekedia on this subject before you read this one.

Today we will focus our attention on arguably the most important economic term on any term sheet – the price per share (PPS).[ii] The price per share is also called the original purchase price (OPP). Needless to say, PPS or OPP is an important number since many other calculations related to other aspects of the term sheet and the investment that is being negotiated depend on that number.

The calculation of the OPP can be straightforward or arbitrary, with arbitrariness being a reflection of the existence of different types of securities.[iii]

The OPP is typically represented in two ways.

In the first way the OPP is described as:

- Representing a fully diluted pre-money valuation of a given amount, and thus
- A fully diluted post-money valuation of a certain sum.

In the second way that OPP is described it is described in terms of the amount of the financing or the aggregate purchase price (APP):

- An aggregate sum that represents a given percentage ownership stake in the startup.
- This characterization is also done on a fully diluted basis.

The following basic relationships govern valuation.[iv]

1. APP = OPP x Aggregate Number of Shares sold in financing round = Amount of the financing
2. Post-Money Valuation = Pre-Money Valuation + APP, or
3. Post-Money Valuation = APP ÷ (% ownership stake)[v]
4. Pre-Money Valuation = Post-Money Valuation – APP
5. Pre-Money Valuation = Pre-transaction PPS x Pre-transaction fully diluted number of shares

As I have already said, valuation is arguably the most important economic term that will be negotiated in term sheet discussions between a startup and its prospective investors.

Next time I will discuss a few qualitative issues that I feel any first time entrepreneur should know very well before entering into any term sheet negotiations.

Let's talk again in two weeks.

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[ii] This series of posts on term sheets is based on the Series Seed Documents, which are made available as open source documents through collaboration between Ted Wang, a partner at Fenwick & West, and the folks at Andreessen Horowitz. You can find the Series Seed Term Sheet here.

[iii] Andrew Metrick and Ayako Yasuda, Venture Capital & the Finance of Innovation, 2nd Edition, 2011, John Wiley & Sons, NJ.

[iv] We are assuming there's only one type of security.

[v] If you watch Shark Tank, this is the method the Sharks use to quickly back into the valuation that the entrepreneur has assigned the entity being pitched to the sharks.

The Anatomy of A Term Sheet: Price – Additional Considerations[i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Last time we focused our attention on arguably the most important economic term on any term sheet – the price per share (PPS).[ii] Today we will explore a few additional considerations that are worth keeping in mind during term sheet negotiations.

1. **Is the quoted valuation post-money or pre-money?** This makes a big difference; usually the term sheet will not be ambiguous on this subject.
    - If the investor is investing $1 million in a startup at a pre-money valuation of $2 million, then the post money valuation is $3 million, and the investor owns about a third of the startup.
    - The same investor investing $1 million in a startup at a post-money valuation of $2 million results in a pre-money valuation of $1 million, and the investor owns about half the startup.
2. **How do you get the best offer from a venture capitalist?** The only way for an entrepreneur to negotiate from a position of strength is to have several financing options. How?
    - A startup with a product that is exploding in popularity with users is in a position of strength. An app developer I am familiar with is in this position – it developed an app that is breaking download records and setting new bars for what it means to be a popular consumer-facing app, paid or free. It is earning enough revenues to cover its costs – in other words, the startup does not have to accept a less than suitable offer. It is also turning away investment offers that do not make sense and only speaking with those that it wants to do business with.
    - Building a long-term relationship with different venture capitalists is important. In any specific round of financing for your startup, more demand is a good thing. So having more than one venture capitalist aware of the progress you have made and interested in an investment works your favor. I would start networking with venture capitalists a year before I think I might need to raise financing – a quarterly update to several venture capitalists on the progress your startup is making should lead to some of them becoming interested in hearing more when you are ready for a follow on round of financing.
3. **What other complicating factors around price should you pay attention to?**
    - The option pool – the size of the option pool makes a significant difference in the economics of the financing. If the option pool is created on a pre-money basis it effectively lowers the price per share. There's a good discussion on this topic at Venture Hacks. You should read it.
    - The presence of other types of securities in the cap table can complicate things down the road. If it is possible, it is worth it to find a more straightforward method to giving the parties what they each want without creating additional complexity.

Let's talk again next time.

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The Anatomy of A Term Sheet: Liquidation Preference[i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Today we will be discussing another important economic term.[ii] The Liquidation Preference is probably the second most important term that you will negotiate with your investors. It is second only to price or valuation.

The Liquidation preference contractually specifies how investors get paid, and in what order they get paid in the event of a liquidation event. We will walk through that in some detail.

What is a liquidation event? A liquidation event is a transaction such that shareholders of the startup do not hold a controlling stake in the entity that is formed as a result of the transaction.

The sample language might be something like this[iii]:

Liquidation Preference:	In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows: [*Alternative 1 (non-participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. The balance of any proceeds shall be distributed pro rata to holders of Common Stock.] [*Alternative 2 (full participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis.] [*Alternative 3 (cap on Preferred Stock participation rights)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).] 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, exclusive license or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "**Deemed Liquidation Event**"), thereby triggering payment of the liquidation preferences described above [unless the holders of [___]% of the Series A Preferred elect otherwise]. *[The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to escrow in connection with a Deemed Liquidation Event.]*

Participation Preference is often closely linked with the issue of liquidation preference.

What is a participation preference?

A Participating Preference contractually grants investors who hold preferred shares the right to "participate" in the pro rata distribution of the proceeds of a liquidation event as if they owned common shares, after they have already been paid back their original investment capital ahead of common shareholders.

This should give you enough to digest.

Let's talk again next time, when we'll walk through some simple scenarios.

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[ii] This series of posts on term sheets is based on the Series Seed Documents, which are made available as open source documents through collaboration between Ted Wang, a partner at Fenwick & West, and the folks at Andreessen Horowitz. You can find the Series Seed Term Sheet here.
[iii] Taken from the NVCA Model Venture Capital Financing Documents at NVCA Model Docs accessed on Nov. 3, 2013.

The Anatomy of A Term Sheet: Liquidation Preference & Participation Preferences, Simple Scenarios[i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Today we will continue our discussion of liquidation, and participation preferences.[ii] The Liquidation Preference is probably the second most important term that you will negotiate with your investors. It is second only to price or valuation.

On second thought, rather than attempt to reinvent the wheel, I'll point you to some really good explanations and examples online. You should read them carefully, and then try to work through some scenarios for yourself to make sure you understand the implications of the scenarios described. These issues can become very complicated, especially as startups raise multiple rounds of financing.

1. Participating Preferred Stock Explained – from CapGenius
2. Participating vs. Non-participating Preferred Stock – from StartupLawBlog

This should give you enough to digest. Let's talk again next time.

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The Anatomy of A Term Sheet: Conversion, Voting Rights, Documentation, and Financial Information [i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Today we will continue our discussion of the conversion, voting rights, documentation and financial information clauses on the term sheet.[ii]

Conversion: It is customary for investors to have the right to convert their preferred stock into common stock at any time they choose to do so, with proportionate adjustments for stock splits, unpaid but accrued stock dividends and so on. Each investor will weigh the opportunity cost associated with a conversion before they decide what to do. In some instances investors earn more for their investment if they do not convert and instead get the liquidation preferences that they negotiated. In other cases they do better if they convert and split the proceeds of an exit event proportionately with other holders of common stock.

Voting Rights: Preferred stock is voted on an as-converted-basis with common stock. That means that preferred stock is counted as if it had converted to common stock, and then votes are counted. On certain issues brought before the board of directors, investors will typically demand majority approval from preferred stock. Here are some examples;

- A change in the rights ascribed to preferred stock,
- A change in the authorized number of shares of the company,
- Authorization of a new class of preferred stock with superior or equal rights,
- Stock redemptions or repurchases that fall outside parameters negotiated between investors and the company,
- Dividend declarations and payments,
- Changes to the number of directors of the company,
- Any events linked to an exit, liquidation, acquisition, merger or another event that has the potential to result in a change of control,
- Other items arising from the specific legal circumstances of the startup's individual founders.[iii]

Documentation: This simply ensures that everyone understand the basis on which the documents will be prepared. If your startup is registered in the United States for example, then it is customary to use the National Venture Capital Association's Model Legal Documents as a starting point. Here is a link to model documents from the BVCA: British Private Equity & Venture Capital Association Standard Industry Documents.[iv] This clause could also outline the legal documents that will be prepared in completing the transaction. Those documents will replace the term sheet, but you should not be surprised if future investors ask to see the term sheet in addition to all the other documents for previous rounds of financing.

Financial Information: It is typical for the counterparties to negotiate information rights for certain "Major Investors" in order to ensure that management does not get bogged down responding to nuisance requests for information. Other investors who do not have information rights will simply be kept up to date through the quarterly updates that management sends to all investors.

This should give you enough to digest till we talk again next time.

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[ii] This series of posts on term sheets is based on the Series Seed Documents, which are made available as open source documents through collaboration between Ted Wang, a partner at Fenwick & West, and the folks at Andreessen Horowitz. You can find the Series Seed Term Sheet here.
[iii] For example, prior legal problems or involvement with another entity that could lead to potential conflicts of interest.
[iv] I could not find model documents for the African Private Equity & Venture Capital Association.

The Anatomy of A Term Sheet: Participation Rights, Board of Directors, Expenses, Future Rights, Founder Matters, and Binding Terms [i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Today we will wrap up our discussion of term sheets.[ii]

Participation Rights: This clause is negotiated by the "Major Investors" in order to ensure that they have the right, not the obligation, to invest in future financing rounds. Major Investors typically want the option to invest in future rounds on a pro-rata basis. In rare cases a Major Investor might want to negotiate for super pro-rata participation rights. Why does the difference matter? First some background, then a brief explanation; Pro-rata[iii] is a term used to denote a proportionate allocation of one thing based on a commonly agreed factor that can be calculated to an agreed upon level of precision. In the specific case of an early stage startup the allocation of a future financing round to existing investors might be calculated on the basis of their pro rata ownership stake in the startup on a fully diluted basis immediately before the new round of financing closes. It is important to specify the basis on which pro rata allocations will be made. I have already described one possibility. Another could be that investors have an option to participate in future financing rounds pro rata to their proportionate participation in a specified past round. Say Investor A invested $250,000 in a $1,000,000 round and a future round of financing for $5,000,000 is being contemplated. Under this scenario Investor A has the right, but not the obligation to invest up to $1,250,000 in the new round.

Typical practice is for investors to seek pro rata participation rights. This ensures that there is alignment between management, founders and investors. Pro rata participation ensures that investors maintain their level of equity ownership in the startup as future rounds of financing are raised. Less common is the practice of investors seeking super pro rata participation rights. In the second scenario I laid out above Investor A would have the right, but not the obligation, to invest more than $1,250,000.

Taken at face value a naïve founder might feel that a super pro rata participation right is always a good thing. Isn't it flattering that a Major Investor might want to buy more of the company as time progresses? However, super pro rata participation rights can create misalignment between investors, founders and management. In certain cases investors with super pro rata participation rights might be unwilling to increase their ownership stake in the startup at the highest valuation that a startup is negotiating with potential new investors for a future financing. This leads to conflicting interests between the startup and its investors. The startup would like to negotiate for the highest valuation it can command on the market. Investors want to increase their ownership percentage in the startup, but not by buying-in at the highest valuation that the market will offer. Such a conflict of interest can lead to further complications that the typical startup should much rather avoid.

Board of Directors: Structuring a board of directors for your early stage startup is incredibly important. A good board is like oxygen. When everything is going well, it seems almost unessential. However, when shit hits the fan the difference between a good board and a bad board becomes excruciatingly clear, much to the detriment of the startup that is saddled with a bad board. Here are some pointers you should consider as you try to structure a board for your startup:

- What kinds of people do you need on the board? What personality types should you try to avoid in order to lower the chance of board dysfunction?[iv]
- What kinds of skills do individual board members need to have in order to be useful to management and the startup?

- How many board members should your startup have? For a seed stage startup 3 board members should be sufficient. A series A startup might be able to justify having 5 board members.
- Who should sit on the board in order to give it some balance, and so that it reflects equity ownership of the startup? What are the loyalties of the individuals you are considering for nomination to a board seat?
    - Here are a few articles you should read, in addition to the one highlighted in the endnotes:
        - 5 Huge Mistakes Startups Make When Choosing Board Members
        - What Makes An Awesome Board Member?

Expenses: Sometimes investors will require that the startup bears the expenses of closing the financing round. Typically this covers legal expenses. Some investors make it a practice to cover their own expenses. I do not have a dogmatic position on this. I think either can be abused, and the most important thing is that the parties trust one another to do the right thing irrespective of which approach is chosen.

Future Rights: This is self-explanatory. In rare occasions a Major Investor in one financing round might try to negotiate for Most Favored Nation status. This is simply an agreement that this investor will always be entitled to terms and rights that are at least as favorable as those accorded to new investors in subsequent rounds of financing. Sometimes this is negotiated in a side-letter between the startup and the Major Investor.

Founder Matters: This clause should cover topics like vesting, intellectual property assignments to the startup by the founders, non-compete clauses, non-defamation and other relevant matters that might arise with relation to the relationship between the startup and its founders.

Binding Terms: This too is self-explanatory. While the term sheet itself is non-binding to either party, the terms of a specific term sheet must be kept confidential. A no-shop clause is typically negotiated as part of this. No-shop and/or non-solicitation clauses are considered binding on the startup.

This wraps up our discussion of the anatomy of a seed stage term sheet. This ought to provide you with a basis for further reading on the topic of term sheets, equity financing, and negotiations. There are several great websites or books that you can use as a launch pad for building your knowledge base on this critically important subject.

Next, we will discuss convertible notes.

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[i] Any mistakes in quoting from my sources are entirely mine.
[ii] This series of posts on term sheets is based on the Series Seed Documents, which are made available as open source documents through collaboration between Ted Wang, a partner at Fenwick & West, and the folks at Andreessen Horowitz. You can find the Series Seed Term Sheet here.
[iii] The technically correct spelling is Pro rata.
[iv] Directors Who Don't Deliver by Jack Welch and Suzy Welch, Oct 18, 2007. Accessed at www. businessweek.com on Jul 5th, 2014.

Convertible Notes 101: An Introduction [i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Today we will discuss an alternative funding mechanism; the Convertible Note.[ii]

Our preceding discussion of term sheets assumed that you and your potential investors agree that the investors should join you as co-owners of your startup. To make that happen you negotiate a value for the portion of the startup that they will own at the end of the investment transaction. The startup gains cash, while its investors gain an equity stake in the startup. If it is not yet obvious, negotiating the details of this exchange can't happen if you cannot agree on the startup's value at that point in its evolution.

Broadly, debt is the other funding alternative that a startup might pursue if equity financing seems unpalatable or unobtainable. Convertible notes are typically described as a form of debt financing. However, it is more accurate to think of them as a hybrid between debt and equity. Generally both parties enter the convertible note expecting that the debt will convert to equity upon the conclusion of a priced equity financing in the future.

I will not spend a lot of time explaining the basic terms that might be outlined in a convertible note term sheet. It will be more useful if I devote most of this conversation to nuances that you should be aware of if this is all new to you. Below is a brief outline of the terms one might expect to find.

Explanatory Outline of Convertible Note for XYZ Awesome Technology Startup – Summary of Proposed Terms for Convertible Promissory Note Financing

- **Financing Amount**: How much are you raising in total. In other words, what will the aggregate principal amount of all the notes be?[iii]
- **Closings**: It is customary to structure this so that there may be one or more closings. This means the founder can raise the aggregate amount over an extended period. A period of one year is not uncommon.
- **Definitive Agreement**: In an equity financing there would be a Stock Purchase Agreement that governs the investment. Similarly, once it has been finalized and entered into by the startup and the individual note holders, the Convertible Note Purchase Agreement supersedes the term sheet.
- **Interest**: This is a loan so it earns interest on a simple or compound basis. The variables that go into the calculation of interest need to be spelled out.[iv]
- **Conversion to Equity**: Describes the conditions under which the notes convert to shares in the startup. Commonly, conversion is mandatory if these conditions are met. Otherwise conversion is voluntary at the maturity date. This clause will usually lay out a few important details;
    - **Equity Financing Amount**: What is the minimum amount of capital the startup raise in the anticipated equity financing?
    - **Valuation Cap or Conversion Price With A Priced Round**: What is the valuation at which the Notes will convert into shares if there is a priced round? More on this later.
    - **Discount**: In lieu of a valuation cap or conversion share price, the notes may convert at a discount to the share price established in the subsequent equity round.[v]
    - **Valuation at Maturity With No Priced Round**: It is a good idea to include details about what happens if the notes reach maturity and there is no prospect of a priced round. Ideally, this should be lower than the valuation cap/conversion price.

- **Sale of the Company**: What happens in the event the startup is sold in an M&A transaction before maturity? It is customary for note holders to be paid an agreed multiple of the principal and interest outstanding at the time of such a sale.
- **Pre-payment**: Under what circumstances may the startup pay-off its indebtedness to note holders before the notes reach maturity?[vi]
- **Amendments and Waivers**: It is customary for amendments and waivers to be allowed as long as the startup and its note holders agree.
- **Security Interest**: The Convertible Notes are an unsecured obligation, and are not secured by the assets of the startup.
- **Fees and expenses**: These are customarily the responsibility of each investor. The startup pays its attorney to draft the documents related to the transaction, but each investor then bears its own costs for reviewing the documentation and closing.

Other Issues/Advanced Topics

- **From The Entrepreneurs' Perspective**
    - **When should I use a convertible note?**
        - **Valuation:** When settling on an acceptable valuation is tricky. One argument in favor of convertible notes is that of cost, speed and efficiency since the debate around valuation is postponed for a subsequent priced round. However, it is not always true that a priced round will be more expensive to execute than a convertible note.
        - **Timing:** When it appears likely that the capital you seek will not all be available at the same time. One attractive feature of a convertible note is that the note can remain open so that the startup is in a rolling fund raising mode, without the need to enter a round of negotiations each time a new investor wants to invest through the convertible note. This has to be acceptable to the majority of note holders at the outset. A priced round is not customarily kept open for as long as a convertible note might be kept open.[vii]
        - **Amount:** Convertible notes are typically smaller in size than priced rounds, hence the desire to minimize complexity where possible.
    - **What else should I be aware of regarding convertible notes?**
        - **The note is a loan**: Your startup could find itself in a position in which it has no choice but to repay some, or all, of the loan. That is not an issue with equity. On the other hand this is not something worth worrying about – perhaps there will be nothing left to hold on to if things come to this. If things are going extremely well, but there's a mutual disenchantment between the startup and one of its note holders then one would expect that a current note holder or another investor would be willing to buy the note in question from its owner.
        - **The valuation cap sets an effective valuation:** but to have no valuation cap or some other explicit understanding of the price at which the notes convert misaligns incentives. Note holders do better the lower the valuation cap.
        - **Anti dilution:** You need to understand how the valuation cap or discount rate affect the amount of dilution that the founders will bear upon the conclusion of a priced round.
        - **Liquidation Preferences:** These can get complicated and messy if you raise multiple convertible notes that eventually become part of an equity round.
- **Investors' Perspective**
    - **When should I invest in a startup through a convertible note?**
        - **Valuation:** When you do not feel capable of arriving at a valuation that will be accepted by the startup as well as other investors who might be contemplating joining a priced round as co-investors.
        - **Timing:** If the note remains open and unfilled, it may be possible to top-up your investment amount before the note is closed to new note holders. For example Fantastic

Nigerian Tech Startup opens a convertible note on January 2, 2015 in the amount of $1.5M. It raises $1.0M of that amount from various note holders between January and June. The note will remain open to new note holders till December 2015. The startup expects to raise a priced round in March 2016. It starts testing its product in August 2015. It could use some extra capital, but additional fundraising would only pull already scarce resources from more productive uses. Some existing holders decide to fill out the rest of the note in October 2015. This makes it possible for the startup to accelerate sales and marketing activities so that it is well positioned for a priced round in early 2016. The additional capital invested in the note in October 2015 is treated as if it had been invested since January 2015 for calculating interest.

- **Amount:** Multiple rounds of convertible notes should be a cautionary sign indicating the need for additional due diligence, particularly if you happen to be considering investing in the second or third note in a series of convertible notes raised by a startup.

- **What else should I be aware of regarding convertible notes?**
  - **Note holders lack control**: Because this is a loan and not equity, investors lack control. The note holders do not get a seat on the board for example.
  - **Note holders lack information rights**: It is not customary for note holders to have information rights, though it is a red flag if the startup is completely non-communicative about how things are evolving.
  - **Note holders lack protective provisions**: Except for pre-payment, the startup can take any actions it wishes to take without obtaining approval from note holders.
  - **The valuation cap sets an effective valuation:** which is better for you if the cap is set as low as possible to reward you for taking early risk. However setting the valuation cap too low risks creating misalignment between the note holders and the startup's founders.
  - **Ask for a pro rata clause:** If things go well and a priced round occurs you should have the option of buying-in at the established price per share in order to maintain your proportionate ownership of the startup.[viii]

Next, we will walk through a simplified example of how some of the arithmetic related to convertible notes might work. See you next month.

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[i] Any mistakes in quoting from my sources are entirely mine. Let me know what you object to and tell me how I could fix the problem.

[ii] There's a set of documents provided by the MaRS Discovery District in Ontario, Canada that you can study. You should look for a few other examples so that you have a sense of the differences in how one might structure the terms. I will keep this discussion broad and very general, but you should work out the specifics as they apply to the country in which you have registered your startup.

[iii] You should have realized that each "Note" represents a separate loan from each note holder to your startup.

[iv] It is unusual for an investor to demand compound interest. Simple interest is most common. You should seek professional advice from an attorney or accountant as to what the minimum should be.

[v] Generally the phrasing will give note holders a choice that is the minimum of the conversion price using the valuation cap, or the discount to the equity round price per share.

[vi] This typically requires consent from the Requisite Holders – often note holders accounting for a majority of the aggregate proceeds of the note. This is analogous to the concept of Major Investors in priced rounds.

[vii] I have seen convertible notes remain open for as long as 12 months. It is rare for an equity round to stay open for that long.

[viii] In some instances it may make sense for note holders to invest substantially more than that in order to close the equity round.

Convertible Notes 101: An Introduction – A Numerical Example [i]

Author: Brian Laung Aoaeh

We started discussing term sheets sometime ago. If you missed those discussions you should consider reading the previous posts titled "The Anatomy of A Term Sheet" before you read this one.

Today we will walk through a simplified numerical example to demonstrate some of the arithmetic and logic associated with Convertible Note financing.[ii] You should read Convertible Notes 101: An Introduction before you proceed with this, since this example will not make much sense without the context we set previously.

The goal of this example is not to turn you into a legal expert on convertible note term sheets. No. My aim is to illustrate some of the logic and thinking that you should become accustomed to as you go through a situation analogous to the one I describe in the example.[iii]

Also, remember that this example might not reflect any reality that you will encounter.

Awesome Ugandan XYZ Tech Startup's Convertible Note[iv]

Awesome Ugandan XYZ Tech Startup (XYZ) is an early stage startup raising $1,500,000. It has decided to raise this round of financing as a series of similar convertible notes (collectively, the "*Notes*"). Here are additional details;

1. **Repayment**: Payable in US Dollars (USD), with a Maturity Date eighteen (18) months from the effective date.
2. **Interest**: Simple interest, on outstanding principal. Interest is payable at a rate of 8% per annum or the maximum rate permissible under Ugandan law, whichever is less. Interest is due and payable on the Maturity Date, and shall be calculated on the basis of a 360-day year for the actual number of days elapsed.[v]
3. **Conversion**; **Repayment of Premium Upon Sale of the Company**: In the event that the Company issues and sells shares of its Equity Securities to investors (the "*Investors*" on or before the date of the repayment in full of this Note in an arms-length equity financing or series of financings resulting in aggregate gross proceeds to the Company of at least $3,000,000 (including the conversion of the Notes and any other debt) (a "*Qualified Financing*"), then the outstanding principal balance of this Note shall automatically convert in whole without any further action by the Holder into such Equity Securities at a conversion price equal to the lesser of (i) (x) 90% of the per share price paid by the Investors if a Qualified Financing happens within twelve (12) months from the date of this Note or (y) 85% of the per share price paid by the Investors if a Qualified Financing happens after twelve (12) months from the date of this Note or (ii) the price equal to the quotient of $8,000,000 divided by the aggregate number of outstanding shares of the Company's Common Stock as of immediately prior to the initial closing of the Qualified Financing (assuming full conversion or exercise of all convertible and exercisable securities then outstanding other than the Notes). At the option of the Holder, the Holder will receive all f the benefits afforded to the Investors in the Qualified Financing. Any unpaid accrued interest on this Note shall be converted into such Equity Securities on the same terms as the principal of this Note.
4. **Maturity**: Unless this Note has been previously converted in accordance with the previously stated and greed terms above, the entire outstanding principal balance above all unpaid accrued interest shall become fully due and payable on the Maturity Date.
5. **Prepayment**: The Company may not prepay this Note prior to the Maturity Date without the consent of the Requisite Holder(s).

XYZ issued 10,000,000 shares of common stock to its founders. The company also established a stock option pool representing 1,500,000 shares of common stock for grants to key employees.

Other Notes

After a series of meetings and extensive due diligence **Ambitious Nigerian VC** (ANVC) decides to invest $500,000 in XYZ's Note. XYZ raises $1,000,000 out of the $1,500,000 it had hoped to raise. Twelve months later, things are going so well that that the Holders decide to invest the remaining amount available under the Note. ANVC invests an additional $250,000.

Three months after the second close XYZ gets unsolicited offers for a Series A round of financing, one of which is from **Big Name Ghanaian VC** (BNGVC) for a $3,500,000 round, at a pre-money valuation of $12,000,000. BNGVC will lead the round by investing $2,500,000. The price per share for the Series A financing is $3.50

XYZ accepts BNGVC's term sheet, and work begins to iron out the details of the documents that will govern the investment.

The series A financing closes 18 months after the first close on the convertible note.

A board of directors is constituted. It has 3 members; one member from ANVC who represents the convertible note holders, one member who represents BNGVC and other new investors, and one founder who is also the CEO.

Question #1: Determine ANVC's ownership stake in XYZ immediately prior to the Series A round of financing.

Solution #1

The value of ANVC's convertible note balance is calculated as follows:

Interest For 18 months on initial Note: $500,000 x (540/360) x 0.08 = $60,000
Principal + Interest = $560,000

Interest for 6 months on second Note: $250,000 x (180/360) x 0.08 = $10,000
Principal + Interest = $260,000

Total pre series A ANCV balance = $560,000 + $260,000 = $820,000

The price per share calculated according to 3(ii) is $8,000,000/10,000,000 = $0.80.[vi]

Total shares due to Convertible Notes Holders = $1,640,000/$0.80 = 2,050,000 (a)
Total shares due to ANCV from Convertible Note = $820,000/$0.80 = 1,025,000 (b)
Total common shares represented by option pool = 1,500,000 (c)
Total common shares held by founders = 10,000,000 (d)

Pre Series A fully diluted shares = (a) + (c) + (d) = 13,550,000 shares.[vii]

ANVC ownership stake = 1,025,000/13,550,000 = 7.564576%

Question #2: Determine XYZ founders' ownership stake in XYZ immediately prior to the Series A round of financing.

Solution #2

XYZ founders' pre series A ownership stake is: 10,000,000/13,550,000 = 73.800738%

Question #3: How much more capital should ANVC invest in the Series A round of financing if it wishes to maintain its pro-rata ownership of XYZ?

Solution #3
New Series A shares issued = $3,500,000/$3.50 = 1,000,000 (e)
Series A fully diluted shares = (a) + (c) + (d) + (e) = 13,550,000 + 1,000,000 = 14,550,000 shares

ANVC pro rata Series A shares = 7.564576% x 14,550,000 = 1,100,646 shares[viii]
Additional shares required to maintain ANVC % ownership = 1,100,646 - 1,025,000 = 75,646 shares

Additional capital required = 75,646 shares x $3.50 per share = $264,761.00

Question #4: How much of XYZ does BNGVC own after the Series A financing is closed?

Solution #4
BNGVC Series A shares = $2,500,000/$3.50 = 714,286[ix]
BNGVC ownership stake = 714,286/14,550,000 = 4.909182%

Question #5: How much of XYZ do XYZ's founders own after the Series A financing is closed?

Solution #4
XYZ founders' % ownership = 10,000,000/14,550,000 = 68.728522%

Discussion

1. **Valuation**: Recall that Post-Money Valuation = Pre-Money Valuation + Investment. Therefore, XYZ closes the Series A with a post-money valuation of $15,500,000.00.
2. **Ownership**: You might wonder why BNGVC does not own a larger share of XYZ. To develop some intuition about that try repeating the calculations on your own using a Series A share price of $0.40, $0.80, $1.60, $2.40, $3.20 and $4.00. What does that exercise tell you?
3. **Full Cap Table**: Spend some time going through the exercise of setting up a full cap table for XYZ. For other investors assume there are other investors; Other Note Investor 1 - $300,000, Other Note Investor 2 - $450,000, and Other Series A Investor 1 - $400,000 and Other Series A Investor 2. Assume ANVC is the only Note Holder with a right of first refusal to maintain its pro rata ownership stake by buying shares in the Series A financing.
4. **Responsibilities**: Attorneys will typically do these calculations on behalf of XYZ and the investors. However, it is not a bad idea for XYZ's founders to understand the logic behind the calculations that go into setting up the cap table.

Do not be fooled. The calculations required to establish the cap-table can become insanely confusing, especially after many rounds of financing. However, while the legalese can be excruciatingly complex, the underlying logic is relatively straightforward. Keep that in mind, and you ought to be able to navigate any cap-table calculations.

See you next month. I have not yet decided what we'll discuss. I am open to suggestions about topics you'd like to see tackled here. I'll announce the topic on twitter when I do – usually about a week before publication. Follow me: @brianlaungaoaeh.

[i] Any mistakes in quoting from my sources are entirely mine. Let me know what you object to and tell me how I could fix the problem.

[ii] There's a set of documents provided by the MaRS Discovery District in Ontario, Canada that you can study. You should look for a few other examples so that you have a sense of the differences in how one might structure the terms. I will keep this discussion broad and very general, but you should work out the specifics as they apply to the country in which you have registered your startup.

[iii] This article is not meant to serve as legal advice, nor is it financial advice of any kind. Please consult a qualified professional for any legal or financial considerations you might have. The scenario described is stylized for learning purposes only.

[iv] This is an idealized example, and therefore a considerable amount of detail has been left out.

[v] It is more common for the day-count convention to be 365 days. I used 360 to make it easier to follow the example.

[vi] You should be able to identify, understand and explain the role of the valuation cap.

[vii] As an exercise you should explain why this is the right calculation.

[viii] I have rounded 1,100,645.808 to the nearest whole number.

[ix] I have rounded 714,285.7143 to the nearest whole number.