Your Dream Destination Awaits!

Getting to Capital Land
An Overview of Common Investment Financing Instruments for Start-ups

Featuring: The 10-Minute Lawyer - A legal issue explained in 10 minutes, followed by Q&A
New Business Practicum

Series C

Series A

IPO / Acquisition

Convertible Note / SAFE / KISS Round
Convertible Promissory Notes

- **Maturity Date**: Date at which the debt becomes due
- **Interest Rate**: Typically 2%-7%
- **Discount Rate**: Rate at which investor gets a discount when converting the note into stock—typically 15%-25%
- **Valuation Cap**: The highest valuation that will apply to the investor’s convertible note
- **Prepayment**: Whether the company can pay off the debt early (and prevent conversion of the note)
- **Pro Rata Participation**: Option to purchase additional equity in future financings

No upfront pricing!
KISS and SAFE Agreements

KISS
Keep It Simple Security (from 500 Startups)

SAFE
Simple Agreement for Future Equity (from YCombinator)

Lack of Debt Features
Foregoes setting an interest rate, maturity date, and prepayment terms

Shadow Series of Stock / SAFE Preferred Stock
Stock that is identical in all respects to Series A Preferred Stock, except for liquidation preference, dividend rights, and anti-dilution protection

Streamlined
SAFE ≈ 4 pages
KISS ≈ 8 pages
Convertible Note ≈ 20 pages
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**Board Seats**
Investor representation on the Board of Directors

**Anti-Dilution**
Protections against a down-round financing in the future
Discount Rate Example

2.2. **Conversion of Notes.**

2.2.1. **Next Equity Financing.** The outstanding principal and unpaid accrued interest of each Note shall be automatically converted into Equity Securities issued in the Next Equity Financing at a price equal to \( [100\% - \text{Discount}] \% \) of the price paid per share for Equity Securities by the investors in the Next Equity Financing (the “Conversion Price”). The number of Equity Shares to be issued upon such conversion shall be equal to the quotient obtained by dividing the outstanding principal and unpaid accrued interest on each Note, on the date of conversion, by the Conversion Price. At least

- $100k promissory note @ 20% discount rate
- During the next priced financing round, the negotiations establish that the company is worth $1.00/share
- The $100k promissory note will convert into shares as if each share were $0.80/share
- Thus, the note would convert into $100,000 / $0.80 = **125,000 shares**
Cap Example

• $100k promissory note @ 20% discount rate and cap of $2.5M
• During the Series A financing round, the negotiations establish that the company is worth $5M @ $1.00/share
• The angel investor will be treated as if the company were worth only $2.5M. Thus, each share would be only $0.50
• Thus, the note will convert into $100,000 / $0.50 = 200,000 shares
• When there is a discount and a cap, the note typically states that the investor will receive whichever share price is lower
Liquidation Preference vs. Money Invested

• Discount rate example:
• Angel Investor: $100k invested @ 80% discount
• Series A: shares priced at $1.00/share (the “Original Purchase Price”)
• Angel Investor gets 125,000 shares for the $100k investment

• As written, the Angel Investor would get $125,000 in liquidation preferences for their $100k investment (assuming a 1X liquidation preference)
Liquidation Preference vs. Money Invested

• Cap example:
  • Angel Investor: $100k invested with $2.5M cap
  • Series A: company worth $5M; assume that VC investors pay $1.00/share (the “Original Purchase Price”)
  • Angel Investor pays $0.50/share and gets 200,000 shares

• As written, the Angel Investor would get $200,000 in liquidation preferences for their $100k investment (assuming a 1X liquidation preference)
• The higher the discount, the lower the cap, the higher the liquidation preference multiple, and the higher the company valuation during the priced round, the larger this “liquidation preference overhang”
Participating Preferred Stock

• Kicks in if the company gets sold

• On a liquidation event, investors with participating Preferred Stock get to “double dip,” so to speak

• Preferred Stock holders would get back their purchase price and then convert into Common Stock, where they would share in the remaining funds
Participating Preferred vs. Non-Participating Preferred

Assume that investors put in $3M at a $7M pre-money valuation with a 1X liquidation preference, and the company gets sold for $20M

Investors will receive their $3M back, and then there will be $17M remaining.

The investors’ Preferred Stock will convert into Common Stock, and then all of the holders of Common Stock will split the $17M.

$17M \times 30\% = $5.1M

Investors will get $5.1M + $3M = $8.1M

$17M \times 70\% = $11.9M

Founders will get $11.9M
Participating Preferred vs. Non-Participating Preferred

Assume that investors put in $3M at a $7M pre-money valuation with a 1X liquidation preference, and the company gets sold for $20M

Investors will get to choose either to convert into Common Stock, or get their investment back according to their Liquidation Preference.

In this case, the investors could either choose to get their $3M back, or they could convert their shares into Common Stock. Here, it makes sense for the investors to convert.

$20M \times 30\% = $6M

Investors will get $6M

$20M \times 70\% = $14M

Founders will get $14M
Appendix
Promissory Notes (convertible) – Key Terms

• Maturity Date
  • Date at which the debt becomes due
  • Typically 1 year

• Interest Rate
  • Typically 2%-7%

• Discount Rate
  • Rate at which investor gets a discount when converting the note into stock
  • Typically 15%-25%

• Cap
  • Highest valuation that will apply to the investor’s convertible note

• Prepayment
  • Whether the company can pay off the debt early (and prevent conversion of the note)

• Pro Rata Participation in Future Rounds

• Liquidation Preference
Interplay with Liquidation Preference
2.2. Conversion of Notes.

2.2.1. **Next Equity Financing.** The outstanding principal and unpaid accrued interest of each Note shall be automatically converted into Equity Securities issued in the Next Equity Financing at a price equal to \[100\% - \text{Discount}\] % of the price paid per share for Equity Securities by the investors in the Next Equity Financing (the “Conversion Price”). The number of Equity Shares to be issued upon such conversion shall be equal to the quotient obtained by dividing the outstanding principal and unpaid accrued interest on each Note, on the date of conversion, by the Conversion Price. At least three (3) days prior to the closing of the Next Equity Financing, the Company shall deliver notice to the holder of each Note at the address last shown on the records of the Company for the Lender or given by the Lender to the Company for the purpose of notice (or, if no such address appears or is given, at the place where the principal executive office or residence of the Lender is located), notifying the Lender of the conversion to be effected and the terms under which the Equity Securities of the Company will be sold in such financing. The issuance of Conversion Shares pursuant to the conversion of each Note shall be upon and subject to the same terms and conditions applicable to the Equity Securities sold in the Next Equity Financing, including any minimum shareholding requirements for the exercise of certain stockholder rights.
**CHARTER**

**Dividends:**

*Alternative 1:* Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock.

*Alternative 2:* The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.  

*Alternative 3:* Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[_____] per share of Series A Preferred when and if declared by the Board.

**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 (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). 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...
TERM SHEET
FOR SERIES A PREFERRED STOCK FINANCING OF
[INSERT COMPANY NAME], INC.
[___, ___, 20___]

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

Offering Terms

Closing Date: As soon as practicable following the Company’s acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the “Closing”). [provide for multiple closings if applicable]

Investors:
Investor No. 1: [_______] shares ([__]%), $[__________]
Investor No. 2: [_______] shares ([__]%), $[__________]
[as well other investors mutually agreed upon by Investors and the Company]

Amount Raised: $[__________], [including $[__________] from the conversion of principal [and interest] on bridge notes].²

Price Per Share: $[__________] per share (based on the capitalization of the Company set forth below) (the “Original Purchase Price”).
Liquidation Preference Overhang Fixes

1. Convert Angel Investor to Preferred Stock up to the 1X liquidation preference, and then Common Stock for the remainder (because Common Stock doesn’t have liquidation preferences)

2. Create a shadow series of Preferred Stock, where the rights are the same as what the Series A investors got, except for:
   • The per share liquidation preference
   • Conversion price for anti-dilution protection
   • Per share basis for dividend rights
Pro Rata Right to Participate

- Tension:
  - Company wants a certain % ownership
  - Angel wants a certain % ownership
  - VC wants a certain % ownership
Pro Rata Right to Participate

• Historically:
  • Angel Investors have been willing to relinquish their pro rata rights, and
  • VCs wanted Angels to continue investing in follow-on rounds.

Signaling:
Angels who want to keep investing = good sign, since Angels don’t have that much money.

Most Angels wouldn’t fight to keep their pro rata, anyway, since they might not have the $. 
Pro Rata Right to Participate

• However, there are now more high-net worth Angels around who want to maintain their stake in follow-on rounds.
• At the same time, VCs trust their due diligence more and do not weight "signaling" as much.
• As a result, VCs battle it out more for positioning.
• Founders and early employees can see some liquidity by selling their own stock in “secondary offerings” (e.g., see Kabam, Secret, Buffer, SurveyMonkey).
Pro Rata Right to Participate

All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company’s stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the “Anti-dilution Provisions” section of this Term Sheet. In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

- NVCA Term Sheet, page 9, under Investment Rights Agreement

Other ways to calculate pro rata right:
- Company capitalization doesn’t include options reserve and options outstanding
- Pro rata calculated based on how many shares the investor has as a proportion of the shares that went out at that round (very narrow-based, rarely seen)
YCombinator’s SAFE

(Convertible Equity)
YCombinator’s SAFE

• Simple Agreement for Future Equity (SAFE)
• “Convertible equity” instrument
• Eliminates the debt terms:
  • Maturity date
  • Interest rate
  • Prepayment
• But keeps the debt-like feature of being able to cash out if there’s an acquisition or dissolution
• Provides for pro rata right to participate based on fully diluted capitalization
• Eliminates the “liquidation preference overhang” by issuing a shadow series of stock
YCombinator’s SAFE

• Simple Agreement for Future Equity (SAFE)
• Four flavors:
  • Valuation Cap, no discount (“Standard SAFE”)
  • Discount, no Valuation Cap
  • Cap and Discount
  • Most-Favored Nation, no Valuation Cap, no Discount
YCombinator’s SAFE – Shadow Series

1. Events

   (a) **Equity Financing.** If there is an Equity Financing before the expiration or termination of this instrument, the Company will automatically issue to the Investor either: (1) a number of shares of Standard Preferred Stock equal to the Purchase Amount divided by the price per share of the Standard Preferred Stock, if the pre-money valuation is less than or equal to the Valuation Cap; or (2) a number of shares of Safe Preferred Stock equal to the Purchase Amount divided by the Safe Price, if the pre-money valuation is greater than the Valuation Cap.

   In connection with the issuance of Standard Preferred Stock or Safe Preferred Stock, as applicable, by the Company to the Investor pursuant to this Section 1(a):

   (i) The Investor will execute and deliver to the Company all transaction documents related to the Equity Financing; *provided*, that such documents are the same documents to be entered into with the purchasers of Standard Preferred Stock, with appropriate variations for the Safe Preferred Stock if applicable, and *provided further*, that such documents have customary exceptions to any drag-along applicable to the Investor, including, without limitation, limited representations and warranties and limited liability and indemnification obligations on the part of the Investor; and

   (ii) The Investor and the Company will execute a Pro Rata Rights Agreement, unless the Investor is already included in such rights in the transaction documents related to the Equity Financing.
“Safe Preferred Stock” means the shares of a series of Preferred Stock issued to the Investor in an Equity Financing, having the identical rights, privileges, preferences and restrictions as the shares of Standard Preferred Stock, other than with respect to: (i) the per share liquidation preference and the conversion price for purposes of price-based anti-dilution protection, which will equal the Safe Price; and (ii) the basis for any dividend rights, which will be based on the Safe Price.
Term Sheet

Priced Round
## Term Sheet – Key Terms

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Pre-Money Valuation

• Value of the company before the influx of investment

• If an investor invests $2M into a company with a pre-money valuation of $8M, that investor will own 20% of the company

For a visual representation of the venture financing lifecycle, see
http://dlopuch.github.io/venture-dealr/
Option Pool Sizing

• The option pool only dilutes the Founders in a Series A financing

• If you sell the company, any un-issued and un-vested options remaining in the pool will be cancelled, and flow through to **all classes of stock** (including Preferred!) proportionally

![Distribution of Equity in Company](image-url)
Participating Preferred

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 (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock.]
Weighted Average Anti-Dilution

**Optional Conversion:**
The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under “Anti-dilution Provisions.”

**Anti-dilution Provisions:**
In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

*Alternative 1: “Typical” weighted average:*

\[
CP_2 = \frac{CP_1 \times (A+B)}{(A+C)}
\]

- \(CP_2\) = Series A Conversion Price in effect immediately after new issue
- \(CP_1\) = Series A Conversion Price in effect immediately prior to new issue

NVCA Term Sheet, page 4
Weighted Average Anti-Dilution

- \( CP_2 = CP_1 \times \frac{(A+B)}{(A+C)} \)

- \( CP_2 \) = New Conversion Price
- \( CP_1 \) = Existing Conversion Price
- \( A \) = Total Shares Outstanding (as converted to common) prior to “down-round”
- \( B \) = # of shares the “down-round” investor would have bought if that investor bought at \( CP_1 \)
- \( C \) = # of shares the “down-round” investor actually bought

Weighted Average Anti-Dilution Example

Financing Rounds

Price per Share ($)

Series A  Series B  Series C

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<th>Series</th>
<th>Price per Share</th>
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<td>1.0</td>
</tr>
<tr>
<td>Series B</td>
<td>2.0</td>
</tr>
<tr>
<td>Series C</td>
<td>0.5</td>
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Weighted Average Anti-Dilution Example

- Assume that immediately prior to Series C:
  - 1,500,000 common stock outstanding
  - 2,500,000 Series A Preferred Stock (issued at $1/share)
  - 2,000,000 Series B Preferred Stock (issued at $2/share)
  - 1,000,000 Stock Options

- 7,000,000 Total shares outstanding (on an as-converted basis)

- At Series C: a down-round occurs, with 2,000,000 shares of Series C Preferred Stock issued at $0.50/share, for a total of $1,000,000
Weighted Average Anti-Dilution Example

• For holders of Series A Preferred Stock:
Weighted Average Anti-Dilution Example

• For holders of Series A Preferred Stock:
  • \( CP_2 = CP_1 \times \frac{A+B}{A+C} \)
  
  • \( CP_2 = $1.00 \times \frac{7,000,000 + ($1,000,000 \div $1.00)}{7,000,000 + 2,000,000} \)

  • \( CP_2 = $1.00 \times \frac{7,000,000 + 1,000,000}{9,000,000} = $1.00 \times \frac{8}{9} \approx$0.88

• Conversion rate = Number of shares \( \times (CP_1 \div CP_2) \)

• Conversion rate = \( 2,500,000 \times ($1.00 \div $0.88) = 1.125 \)
  • This means that for every share of Series A Preferred Stock the stockholder trades in, the stockholder will get 1.125 shares of Common Stock
Weighted Average Anti-Dilution Example

• For holders of Series B Preferred Stock:
Weighted Average Anti-Dilution Example

• For holders of Series B Preferred Stock:
  
  \[ CP_2 = CP_1 \times \frac{A+B}{A+C} \]

  \[ CP_2 = $1.00 \times \frac{7,000,000 + (1,000,000 \div 2.00)}{7,000,000 + 2,000,000} \]

  \[ CP_2 = $1.00 \times \frac{7,000,000 + 500,000}{9,000,000} = $1.00 \times \frac{7.5}{9} \approx $1.67 \]

  • Conversion rate = Number of shares \( \times (CP_1 \div CP_2) \)

  • Conversion rate = 2,000,000 \( \times (\$2.00 \div $1.67) \approx 1.2 \)
    
    • This means that for every share of Series B Preferred Stock the stockholder trades in, the stockholder will get 1.2 shares of Common Stock
Weighted Average Anti-Dilution Example

• Note: this example walked through a broad-based weighted average formula, which took into account all shares of Common Stock outstanding, all Preferred Stock (as converted to Common Stock), Common Stock issuable upon exercise of outstanding options, and Common Stock reserved in the Options Pool.

• There are other ways to calculate weighted-average anti-dilution, by considering a smaller number of shares as the “Total Outstanding Shares.”
  • In some variations, only the Common Stock as-converted from the series of Preferred Stock being adjusted is considered in the “Total Outstanding Shares” variable.
  • In other variations, Common Stock as-converted from all outstanding Preferred Stock is what makes up the “Total Outstanding Shares” variable.