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ANATOMY OF A TERM SHEET: EARLY STAGE TERM SHEETS

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Genus Heidary is an experienced litigator and regulatory attorney, helping energy, technology and consumer finance industry clients, among others, resolve their most pressing issues.

Devoting much of her time to environmental and white collar law, Genus frequently navigates internal investigations and civil and criminal enforcement matters, including those implicating fraud and abuse, consumer finance, the Clean Air Act, clean technologies and the Occupational Safety and Health Act.

As a member of Katten's Consumer Finance practice, Genus also concentrates on class action and multidistrict litigation. She focuses her practice on defending clients against state and federal class actions, with particular emphasis on consumer protection and consumer finance laws.

With significant life sciences experience, Genus works with Katten's Food Outbreak and Product Recall team. Prior to entering the field of law, Genus worked in the public health policy arena in numerous capacities at both the local and federal levels, including serving under the San Mateo County Director of Health Services and as a Congressional Fellow in the Office of Congresswoman Hilda L. Solis.

At the University of California, Los Angeles, Genus was the Ann G. Quealy Memorial Fellowship recipient for "Outstanding Graduate." While in law school, she externed for the Honorable Consuelo M. Callahan, US Court of Appeals for the Ninth Circuit, and for the Honorable Otis D. Wright II, US District Court, Central District of California. During this time, she also was a law clerk at the Los Angeles County Public Defender's Office, an editor of the *Pepperdine Dispute Resolution Law Journal* and a member of the Moot Court team, for which she finished as a finalist in both domestic and international competitions.

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Jonathan Weiner focuses his practice on transactional, securities and general corporate matters. He regularly handles public and private financings (including private investments in public equity and other structured equity and equity-linked investments), mergers and acquisitions, joint ventures, recapitalizations, and other complex transactions on behalf of private equity funds, hedge funds, investment banks, operating companies, boards of directors and independent committees. In addition to transactional matters, Jonathan serves as outside counsel for public companies, private equity-sponsored portfolio companies, start-ups and family-owned businesses, advising them on a day-to-day basis regarding corporate governance, securities law compliance, disclosure issues and other matters. Jonathan's skill set combines deep understanding of corporate and securities laws and corporate governance "best practices," with perspective gleaned from broad experience at all stages of the corporate lifecycle.

Jonathan also has extensive experience advising clients in connection with the formation and management of joint ventures, strategic partnerships, equity co-investments, venture capital investments and seed transactions. He counsels these clients on a wide range of issues, including minority investor protections, preferred and convertible securities, incentive equity arrangements, buyback provisions, put rights, liquidity and transfer rights (and restrictions), governance matters and exit events. Jonathan's clients operate in a wide array of industries, including financial services, fitness, consumer brands, cybersecurity, health care, publishing, technology and industrials, among others. His multidimensional skill set enables him to provide creative and practical solutions to legal challenges.

AN OVERVIEW – NOT LEGAL ADVICE

The issues set forth below are intended to provide a practical overview regarding term sheets. This presentation is not intended to constitute "legal advice."

What is a Term Sheet?

A nonbinding agreement that sets forth the basic terms and conditions under which an investment will be made.

- Some terms are binding: E.g., Confidentiality and Counsel and Expenses clauses
  - "No-shop/Exclusivity clause," common to term sheets in later phases of funding, is generally also binding.
- In some jurisdictions, a non-binding term sheet creates an enforceable obligation to negotiate in good faith.
- Roadmap to lawyers to draft actual agreements.

Term Sheet: Skeleton

A term sheet generally can be broken down into four sections:

1. Funding
2. Corporate Governance
3. Liquidation and Exit
4. Other Legal Terms

FUNDING TERMS

Funding Terms

- Amount of the Investment, i.e., “offering terms”
- Who will be the investor
- Valuation
  - “Pre-money valuation” - imputed dollar value given to the company before the new money is invested.
  - “Post-money valuation” - pre-money valuation + the amount invested.
- Type of Funding i.e., whether it will be in a lump sum or in tranches (generally, these are triggered by pre-determined milestones)
- Type of security issued, which may be equity in the form of convertible preferred stock, common stock, convertible note or debt
- Protections from dilution, which may include anti-dilution, pre-emptive rights/ rights of first refusal
- Pre and post Financing Capitalization Table

Early-Stage Term Sheets: Examples of Securities

- Common Stock:
  - “Common stock” - basic unit of equity ownership
  - Issued to founders, employees, consultants etc.
  - Most common form of security, yet investors in early stage rounds (e.g., friends and family or Series A) rarely use it.
- Senior-equity security: E.g., Convertible preferred stock
  - “Stock” - Equity ownership, thus second to debt
  - “Preferred” - Preference over common stock on dividends, distributions, liquidation, and redemption.
  - “Convertible” - Convertible into common stock, with all the upside of common stock.
  - Early-stage investment rounds (i.e., Series A) commonly use this.
- Debt: Subordinated Debentures with warrants

Early-Stage Term Sheets: Examples of Securities

- Convertible note: Debt instrument used to facilitate investing in a company establishing valuation, which generally converts to Series A preferred stock at a later date subject to a conversion price discount and/or a conversion price cap.
  - Because it is debt, it sits above equity in the "capital stack."
  - Common conversion occurs upon "qualified financing" (generally an equity financing of a certain size).
- SAFE: "Simple Agreement for Future Equity." Replacement for a convertible note, where in exchange for money through a SAFE, the Investor gains the right to purchase stock in a future equity round based on certain parameters. Commonly used by start-ups because e.g., reduces (1) threat of insolvency caused by convertible note,(2) maturity date extension requests, and (3) legal cost of negotiating convertible note etc.
  - Generally, not favorable for investors.

Privileges of the Security

The details of the security will include such features as:

- Price per share
- Dividends or interest payments
- Preferences on liquidation, which includes rights of debt holders to any collateral
- Conversion rights, which includes conversion ratio and time when conversion is permissible or required
- Conversion caps for convertible notes
- Antidilution provisions
- Redemption provisions
- Voting rights of security holders

Antidilution (AD): Non-price based AD

Most early-stage investments involve several rounds of funding. The AD term is designed to protect investors from the changes that can occur between the rounds of investment.

1. Structural AD protection: Protects against the effects of stock dividends, stock splits, reverse splits and other recapitalization. Generally, structural AD adjusts the conversion price (CP) of the preferred stock, which is initially set to be the same as the original purchase price.

Antidilution (AD): Non-price based AD

2. Right of first refusal (i.e., Preemptive Right or Right to Participate): Allows the preferred stockholders to purchase a pro rata share of the company's future stock issuance (or sale of stock by the founders).
   - This is particularly important to protect investors' ownership in "underpriced rounds" and "up rounds" of financing (where subsequent round is at a pre-money valuation that is higher than post-money valuation of prior round).
   - Common exception to these rights relates to the sale of stock to strategic partners, consultants, employees or directors.
   - Common condition on these rights is that an investor must hold a minimum % of preferred stock in order to exercise right.
   - Common for Entrepreneur to request a reciprocal right, i.e., company or entrepreneur has right of first refusal on sales of preferred stock by the investor.

Antidilution (AD): Price-based AD

Triggered by reductions in the price of shares sold to investors in subsequent rounds (i.e., price-based difference).

- Price Protection from Dilutive Effects: Valuation of early-stage companies is uncertain and investors could be investing in a company whose value adjusts downward before it resumes positive growth.
  - Two Principal Forms of Price-Based AD protection:
    1. Full-ratchet AD: Adjusts to the lowest price at which a single share is sold
    2. Weighted-average AD (WAAD): Most frequently used in early stage

CORPORATE GOVERNANCE

Corporate Governance

As outlined within the certificate of incorporation and company by-laws and often specified within the term sheet:

- Distribution of decision-making powers
- Board composition
- Voting rights (“protective provisions”)
- Revisions to the by-laws
- Management and Information rights

Control Rights

Allow investors to exercise overt control over key company decisions

1. Board Representation
    - Directors owe fiduciary duties to the company, its shareholders, and these create substantial legal liabilities. Investors may prefer to exercise control through protective provisions.
        - *Trados Inc.* - venture capital interests and director fiduciary duties in conflict.
    - Observation rights: permit an investor representative to attend board meetings but does not permit voting or impost fiduciary duties.
2. Voting Controls i.e., protective provisions
    - Rights can be structured so that, if the company fails to meet milestones or breaches contract terms with regard to the preferred stock, the preferred stockholders may acquire the right to elect the majority of the board.

Board of Directors: Protective terms

Pro Investor: Board Representation	Neutral: Board Representation	Pro Entrepreneur: Board Representation
Elect Majority of Board	Elect representative to Board	Elect representative as board observer

Pro Investor: Protective Provisions (Voting Controls)	Neutral: Protective Provisions (Voting Controls)	Pro Entrepreneur: Board Representation
80% approval of preferred shareholders necessary for certain action (extensive list)	2/3 approval of preferred shareholders necessary for certain actions (moderate list)	50% approval of preferred shareholders necessary for certain actions (limited list)

Management and Information Rights

A Management Rights Letter is often required to be submitted to a “Major Investor” and is included in the Term Sheet:

- Grants Major Investor access to Company facilities and personnel during normal business hours and reasonable notice;
- Grants right to periodic issuance of financial statements and other information deemed necessary by the board; and/or
- Grants right to a comprehensive operating budget forecasting the Company’s revenues, expense, and cash position for the upcoming fiscal year.

LIQUIDATION AND EXIT

Liquidation and Exit Terms

- Exit Strategy
- Redemption rights
- Registration rights
- Drag-along and tag-along rights
- Participation rights

Liquidation Preference

Stipulates the amount of money that must be paid to preferred shareholders upon a liquidation, dissolution, or sale of the company prior to the distribution of any proceeds to the common shareholders (applies to equity only as debt is always senior to equity).

Common Forms:

1. <u>Single-dip preference</u> (conventional liquidation preference)
2. <u>Double-dip preference</u> (participating deferred): removes the choice investors face under a conventional preference; investors receive liquidation preference (first dip), but also participate with the common stockholders as if converted (second dip)
3. <u>Multiple on Invested Capital (MOIC)</u>: Upon early sale

Redemption Rights

Investor's right to force the company to redeem, i.e., buy back, the investor's stake at a stated time (or when a particular condition is met).

- Provides Investor a specified liquidity event.
- Entrepreneurs often feel pressure by this term as it may
  - lead to conflicting incentives between the preferred and common shareholders; or
  - deter future investors as they may feel their funds would be used to pay for the redemption.
- Investors favor this provision because it establishes a point in time to fulfill return expectations to investors and may provide leverage to force a sale.

Redemption Rights

Redemption Rights are commonly restrained e.g.,

- Right exercisable after some period of time;
- Redemption conditioned on the approval of a percentage of shareholders; or
- Redemption may be paid over a period of years.

Other Liquidation and Exit Terms

- Co-Sale ("tag-along") rights: ability to sell alongside founders/management (and sometimes also other investors).
- Drag-along rights: ability to force stockholders to go along with a sale that meets certain conditions.
- Pay to Play: ability of investors to force each other to invest in future rounds.

Other Legal Terms

Other Legal Terms

- Key Employee Agreements: Term sheet may specify that employee agreements be signed and include certain protections e.g., non-competition and non-solicitation agreements, and non-disclosure and developments agreements.
- Conditions Precedent to Funding: Investor will specify conditions that must be met prior to funding e.g., performance of due diligence, legal counsel review.
- No-Shop clause: Entrepreneur agrees that during the due diligence phase, the company will not initiate or accept offers from other funding sources (uncommon in angel round funding).

Other Legal Terms

- Expiry Date: Date by which the term sheet must be signed
- Target closing: Closing date by which due diligence must be complete
- Restrictions on Sale or Issuance of Shares: Investor will often stipulate that without its express approval, existing shareholders are not allowed to transfer or sell shares within a specified number of years.

Common Agreements Prompted by Term Sheet

- Certificate of Incorporation
- Company By-law Amendments
- Voting Agreement
- Shareholder’s Agreement
- Purchase Agreement
- Legal Opinion
- Management Rights Letter
- Investor Rights Agreement
- Indemnification Agreement
- Confidential Disclosure Agreement
- H.R. Best Practices for Addressing Harassment and Discrimination
- Code of Conduct Policy
- Diversity and Inclusion Policies
- Parental Paid Leave Policy

Discussion and Case Study

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