Q2 ‘20 Member Meeting
<u>Invited Speaker Presentation</u>

Convertible Notes:
Must Haves and Nice to Haves

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Not Covered Today: Standard Terms, Rationale, Mechanics

- Caveat: Most angels generally prefer priced equity rounds (Common, Series A, or Series Seed) to convertible notes
- The valuation cap in a convertible note should not be confused with the pre-money valuation
  - **Eschenbach Equivalency Rule**: The cap in a convertible note is roughly equivalent to 2/3 of a pre-money priced round valuation (*example*: a priced round pre-money valuation of $6M is equivalent to a convertible note valuation cap of $4M)
- A 20% discount by itself on the next equity round is not sufficient return to justify providing debt to fund a company's growth
- Amos makes a distinction between convertible notes used as a short term bridge versus as a seed funding instrument.

1. Conversion on Change of Control

- If there is an acquisition before there is a conversion, there can be different scenarios: (i) Lender gets money back, plus interest (where there is no specific language addressing acquisition; (ii) Lender gets money back, plus interest, plus a multiple of the original principal amount (usually 1X or 2X); (iii) some right to convert does occur (to acquired company's common stock or preferred stock)
- Notes sometimes say that they are:
  - Repayable at the option of the holders, or
  - the notes are either repayable or convertible into equity at the option of the holders; and sometimes that the notes automatically convert into equity.
- Best approach is to allow the note holder (or a majority of the note holders) to elect to receive stock in lieu of repayment. Sometimes it's a conversion, if converting to stock is economically in the best interests of the holder (not an election).

Sample Language:

- **Minimal / Not Great:** Conversion or repayment of this Note, the entire principal amount of and accrued interest on this Note shall be repaid to the Lender in the sum of all of the then accrued but unpaid interest plus 100% of the principal amount of the Note upon the closing of the Change of Control transaction . . . "
- **Better:** "If the Company consummates a Change of Control (as defined below) while this Note remains outstanding, the Company shall repay the Holder in cash in an amount equal to 2.0 times the outstanding principal amount of this Note plus any unpaid accrued interest on the original principal; *provided*, *however*, that upon the written election of the Holder made not less than 5 days prior to the Change of Control, the Company shall convert the outstanding principal balance of this Note and any unpaid accrued interest into shares of the Company's Common Stock at a conversion price equal to the quotient resulting from dividing **[$ Valuation Cap]** by the number of outstanding shares of common stock of the Company immediately prior to the Change of Control . . . ."

2. Option Pools and Increases

- Conversion price can involve a calculation where "Fully Diluted" is the denominator. A higher denominator = lower share price (better for investors).
- The definition of "Fully Diluted" should include any increase in the option pool at the time of the Qualified Equity Financing – i.e., Include shares that are or will be reserved for the Company's equity incentive plan in the calculation of outstanding shares of common stock. Three components to this:
  - Options and warrants that are <u>outstanding</u> prior to the investment (even if the options may never be actually exercised).
  - Options / shares that have been <u>set aside in an employee option plan even if yet granted</u> at the time of an investment. Assumes that (i) the company will grant options for all such set-aside shares in the future and (ii) the holders will exercise their options for stock.
  - Options / Shares that may be <u>set aside as part of the QEF</u>: It's fairly common that additional options are set aside, and the fully diluted capitalization should include all such new shares. (*But see* Post-Money SAFE - - The Post-Money Valuation Cap is "post" the Options and option pool existing prior to the Equity Financing. It is NOT also "post" the new or increased option pool adopted as part of the Equity Financing (e.g. Series A. Rationale: YC treats the SAFEs as an independent fundraise from the Series A in which they convert. The option pool that is created or increased as part of the Series A is intended to provide equity for the people hired after the Series A.)

Definitions

- In most of the early stage financings the option pool is around 10% of fully diluted in unissued options. So if a convertible note is converted on a QEF, the company may want to add additional options.
- "Issued and outstanding" = the number of shares actually issued by the company to shareholders – does not include authorized but unissued, and outstanding options are not counted because they only represent a right to purchase shares in the future when they are "exercised."
- "Fully diluted" usually means issued stock (common and preferred stock, as if converted to common stock), issued options (or warrants, which are similar to options) and (usually) options reserved in the stock option pool, as if the entire option pool has been granted, and that all of those options have been exercised.

Sample Language

- **Conversion upon a Qualified Financing.** In the event that the Company issues and sells shares of its equity securities ("***Equity Securities***") to investors (the "***Investors***") on or before the Maturity Date in an equity financing with total proceeds to the Company of not less than $1,000,000 (excluding the conversion of the Notes or other convertible securities issued for capital raising purposes (*e.g.*, Simple Agreements for Future Equity)) (a "***Qualified Financing***"), then the outstanding principal amount of this Note and any unpaid accrued interest shall automatically convert in whole without any further action by the Holder into Equity Securities sold in the Qualified Financing at a conversion price equal to the lesser of (i) the cash price paid per share for Equity Securities by the Investors in the Qualified Financing multiplied by 0.80, and (ii) the quotient resulting from dividing $5,000,000 by the number of outstanding shares of Common Stock of the Company immediately prior to the Qualified Financing (assuming conversion of all securities convertible into Common Stock and exercise of all outstanding options and warrants, including all shares of Common Stock reserved and available for future grant under any equity incentive or similar plan of the Company, and/or any equity incentive or similar plan to be created or increased in connection with the Qualified Financing, but excluding the shares of equity securities of the Company issuable upon the conversion of Notes or other convertible securities issued for capital raising purposes (*e.g.*, Simple Agreements for Future Equity)).

3. Conversion at a Non-Qualified Financing

Non-Qualified Financings are typically equity sales which are below the threshold of a Qualified Financing.

See if the note gives the holder option to treat any equity financing transaction, in which Preferred Stock is sold, as a Qualified Financing

- If yes, that gives note holders the option to convert upon a non-qualified financing.
- Such election can be made either upon the election of the Majority Holders, or upon the election of a Holder

Sample Language from Typical Note

- **Conversion upon a Non-Qualified Financing.** In the event that the Company issues and sells shares of its equity securities (the "***Equity Securities***") to investors (the "***Investors***") while this Note remains outstanding in an equity financing with total proceeds to the Company of less than **[$ Amount]** (excluding the conversion of the Notes or other indebtedness) (a "***Non-Qualified Financing***"), then at the option of the Holder, the outstanding principal amount of this Note and any unpaid accrued interest shall automatically convert in whole (after obtaining written approval from the Holder) into such Equity Securities sold in the Non-Qualified Financing at a conversion price equal to the lesser of (i) the price paid per share for Equity Securities by the Investors in the Non-Qualified Financing multiplied by **[The Discount Rate]**, and (ii) the quotient resulting from dividing **[$ Valuation Cap]** by the number of outstanding shares of common stock of the Company immediately prior to the Non-Qualified Financing . . . .

4. Most Favored Nations

- The “MFN” clause states that if the company issues any more convertible debt after this note or series of notes with more favorable terms, then the older note holder will automatically get those more favorable terms.
- Including this type of clause is not typical, but some situations may call for it.
- Example: An MFN is sometimes seen on uncapped convertible notes as a way to balance a company’s desire not to cap the note, and an investor’s concern that a capped note may subsequently be issued.

MFN Sample Language

- **Most Favored Nations.** If, while this Note is outstanding, the Company issues other indebtedness of the Company convertible into equity securities of the Company, or amends any existing indebtedness convertible into equity securities of the Company, and such newly issued or amended indebtedness would have material terms that are more favorable, from the perspective of the Holder (the "***Other Debt***"), than the terms of this Note, then the Company will provide the Holder with written notice thereof, together with a copy of all documentation relating to the Other Debt and, upon request of the Holder, any additional information related to the Other Debt as may be reasonably requested by the Holder. The Company will provide such notice to the Holder promptly (and in any event within 30 days) following the issuance of the Other Debt. In the event the Holder determines that the terms of the Other Debt are preferable to the terms of this Note, the Holder will notify the Company in writing within five days following the Holder's receipt of such notice from the Company. Promptly after receipt of such written notice from the Holder, but in any event within 30 days, the Company will amend and restate this Note to be substantially identical to the promissory note evidencing the Other Debt, excluding the principal and unpaid accrued interest.

5. Board Representation for Noteholders

- Not very common. In a priced round, investors are typically granted certain control rights, including a Board seat and veto rights with respect to certain corporate actions (such as the sale of the company) pursuant to so-called "protective provisions."
- Convertible noteholders are rarely granted control rights. For example, in Fenwick & West's Seed Financing Survey, convertible noteholders were granted a Board seat in only 4% of the seed financings; while preferred stockholders were granted a Board seat in 70% of such financings.
- Often a "Major Investor" (often, whomever write a large check) can designate a Board member.

Sample Language

- *Board Composition*. For purposes of this Section ____ a “Major Investor” shall mean an Investor that, together with its affiliates, purchases one or more Notes with an aggregate Purchase Price equal to or exceeding $______,000. As soon after the Initial Closing as is practically possible, the size of the Board shall be expanded from one (1) directors to three (3) directors. The composition of the Board shall be as follows: (a) the current Chief Executive Officer, (b) another member of management or otherwise representing the Company, who shall be _________, (c) one individual designated by a majority of the Major Investors and who shall be acceptable to a majority of the then-serving members of the Board acting in good faith, who initially shall be ________________. The Major Investor Board Director may be replaced by any other individual designated by a majority of the Major Investors provided, that (y) such replacement shall be requested in writing by a majority of the Large Major Investors and delivered at least ten days in advance of the desired effective date of such replacement and (z) such individual shall be acceptable to a majority of the then-serving members of the board, acting in good faith. By agreeing to serve on the Board, the Major Investor Board Directors agrees to resign his or her Board position if reasonably requested by the Company to do so as part of a Qualified Financing.

6. Pro-rata Rights in Future Rounds

- Pro rata rights are an investor's right to invest money in the next round, and in an amount that will maintain the investor's current ownership percentage.
- Unless a pro-rata right clause is explicitly listed in the convertible note terms, convertible note holders do not get pro-rata rights. Generally speaking, convertible notes <u>do not</u> include a pro rata right clause.
- *Where it is Seen:* Financings in which the lead investor is an institutional investor (like a venture fund).
- Even if pro-rata right terms are included in a convertible note, a Series A round lead will sometimes request prior investors to waive their pro-rata rights. *Rationale:* The Series A lead investor (at least, the lead investor) will probably expect to receive some percentage (say, 15-20%) of the fully-diluted, and may not get there if noteholders have pro-rata rights.

Example Language – One Year Right; Not Pro-Rata

- Pro Rata Right. Each time the Company proposes to issue and sell Equity Securities at a fixed pre-money valuation, at any time for a period ending one (1) year from date of this Note, the Company shall provide Payee with at least ten (10) business days prior written notice of such offering, including the price and terms thereof. Payee shall have a right of first offer to participate in such offering(s), on the same terms and for the same price as all other investors in such offering(s), by purchasing an aggregate number of Equity Securities (whether in one offering or across multiple offerings) valued at up to the this Note purchased by Payee. The Payee's right of first offer set forth in this Section 6(f) shall be subject to compliance with applicable federal and state securities laws..

7. Information Rights

- Typically applies to financial statements; sometimes "update on Company business developments".
- If defined, "*Financial Statements*" usually means an income statement, balance sheet, statement of stockholders' equity, and/or a statement of cash flows, in each case as of the end of (i) each of the first three (3) fiscal quarters and (ii) each fiscal year of the Company.

Sample Language (KISS; Altrix Bio)

- In the event the Investor, together with its affiliates, purchases one or more KISSes with an aggregate Purchase Price equal to or exceeding $50,000 (a "*Major Investor*"), the Company shall provide such Major Investor with the following rights:
  - Information Rights. To the extent that the Company prepares Financial Statements, the Company shall deliver to the Major Investor such Financial Statements upon request, as soon as practicable, but in any event within thirty (30) days after the end of each of the first three (3) quarters of each fiscal year of the Company and within ninety (90) days after the end of each fiscal year of the Company. Such Financial Statements shall be in reasonable detail and prepared on a consistent basis. Additionally, regardless of whether the Company prepares Financial Statements, the Company shall deliver to the Major Investor such information relating to the financial condition, business or corporate affairs of the Company as such Major Investor may from time to time reasonably request.
- Altrix: "The Company will provide on a bi-monthly basis an update on company business developments and financing activity as well as furnish to each Purchaser upon request when available quarterly unaudited financial statements for each fiscal quarter of the Company, all prepared in accordance with generally accepted accounting principles and practices, subject to changes resulting from normal year-end audit adjustments.

8. Conversion at Maturity

Handled in many ways. Some ventures will attempt to "stack" their convertible notes, and don't bother seeking a priced round. Also very important in life sciences, when a venture shows great data, and you're a mere noteholder. Frequent alternatives:

- Silent
- Cash repayment obligation is triggered on the maturity date
- Notes are repayable at the option of the holders or majority of holders
- Notes are either repayable or convertible into equity at the option of the holders or majority of holders
- Notes automatically convert into equity (common or preferred; if preferred, the preferences need to be pre-specified, or specify standard Series Seed terms (at seriesseed.com; now at V. 3.2), such as 1X non-participating liquidation preference, broad-based antidilution, and a Board seat for the Series Seed investors

Sample Language- Conversion to Common

- Conversion at Maturity. In the event that (i) a Qualified Financing or Non-Qualified Financing shall not have occurred on or before the Maturity Date, or (ii) a Change of Control shall not have occurred on or before the Maturity Date, then, at the option of the Payee, the outstanding principal amount of this Note and any unpaid accrued interest shall automatically convert in whole (after obtaining written approval from the Payee) into shares of Common Stock at a conversion price equal to the quotient resulting from dividing the Valuation Cap by the number of outstanding shares of common stock of the Company immediately prior to the conversion (assuming conversion of all securities convertible into common stock and exercise of all outstanding options and warrants, but excluding the shares of equity securities of the Company issuable upon the conversion of Notes or other indebtedness). In the event that the Payee chooses not convert to Common Stock at Maturity, both Payee and Company shall decide on a course of action at maturity, whether to extend the Note Maturity date, or to exercise the Payee's right to have the Note and any unpaid accrued interest paid to the Holder upon demand.

Sample Language- Conversion to New Series Preferred

- **Maturity Date Conversion.** In the event that this Note remains outstanding on the Maturity Date, then the outstanding principal balance of this Note and any unpaid accrued interest shall upon the election of the Holder given prior to the Maturity Date, convert as of the Maturity Date into shares of a newly created series of the Company's preferred stock on the terms and conditions set forth on **Exhibit A** at a conversion price equal to the quotient resulting from dividing $___,000,000 by the number of outstanding shares of Common Stock of the Company as of the Maturity Date (assuming conversion of all securities convertible into Common Stock and exercise of all outstanding options and warrants, including all shares of Common Stock reserved and available for future grant under any equity incentive or similar plan of the Company, but excluding the shares of equity securities of the Company issuable upon the conversion of Notes or other convertible securities issued for capital raising purposes (*e.g.*, Simple Agreements for Future Equity)).

- *Source: Cooley GO*

Preferences on Stock Issued on Maturity (typically in "Exhibit A")

- Securities (Preferred Stock)
- Liquidation preference
- Conversion
- Automatic conversion
- General voting rights
- Protective provisions
- Right to maintain proportionate ownership
- Information rights
- Other Matters: 180 day lock up, etc.