Making the Most of Your Round – Preferred Stock Financing Topics

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Topics Covered

Overview of options for early-stage financing:
Convertible Notes, SAFEs or Preferred Stock

Preferred Stock Financings:

Economic Considerations

Governance and Management Issues

Exit and Liquidity Matters

Venture Financing Trends

OPTIONS FOR EARLY-STAGE FINANCING

Options for Early-Stage Financing

Convertible Notes

- Simple forms; easy to negotiate and implement
- Generally used to bridge the gap before the company's first "true" financing (or between company financings)
- Negotiated Terms:
  - Discount rate
  - Valuation cap
  - Interest rate
  - Maturity date

Options for Early Stages Financing

Simple Agreement for Future Equity ("SAFEs")

- Introduced by Y Combinator in 2013
- Intended to replace convertible notes – also simple forms; easy to negotiate and implement
- Similar to a warrant but without a specific price per share at the time of investment
- Originally utilized to raise smaller amounts of money
- Key Terms: fewer than convertible notes
  - Discount rate
  - Valuation cap
- Form updated in 2018 to reflect:
  - Founders increasingly using SAFEs to raise entire stand-alone rounds
  - Transition to a post-money valuation cap
- SAFE Investors increasingly requesting additional protections (e.g., information rights, conversion upon a date certain, etc.)

SAFEs vs. Convertible Notes

Notes	SAFEs
Simple form, few terms	Simpler form (debatable), fewer terms; costs may be equivalent
Maturity Date	No requirement that Company repay or deadline for conversion; Investor bears risk of non-conversion
Until conversion, generally has the same treatment as typical debt: entitled to Company assets in the event of liquidation, can declare a default	SAFE Investors entitled to nothing in a liquidation, cannot declare a default
Investor will receive either cash or equity	Investor will receive either equity or nothing (can be cashed out in a sale transaction)
For Investors: notes treated as debt/convertible equity	For Investors: SAFEs not considered stock that can be written off as an ordinary business loss (if unsuccessful in converting)

Options for Early-Stage Financing

Preferred Stock Financing: Series Seed or Series A

- Results in a true agreed Company valuation
- Many more terms to negotiate (discussed ahead)
- Two options for documents to build from:
  - Series Seed: simpler; easier to negotiate
  - Series A: will require less amending in connection with next round
- Side Letters – particularly for strategic investors

PREFERRED STOCK FINANCING: KEY DEAL TERMS

Key Deal Terms – Basics

- The Investors
  - Lead Investor(s)
  - Working with a syndicate/foreign investors (CFIUS)
  - Sophistication/VC experience of investors and their counsels
  - Strategics vs. traditional VCs
- The Founder(s)
  - It's your baby!
  - Ego
  - Dilution
- Management/Key Employees
  - Ego
  - Dilution / Retention
- Size of raise (total raise and allocation across syndicate)

Key Deal Terms – Economics

- Valuation (and its components)
  - Conversion of existing debt or convertible securities into Common or Preferred Stock
  - Size of equity compensation pool
  - Treatment of promised but unissued options
- Liquidation preference
  - Senior or *pari passu* (only for later rounds)
  - 1x or more
  - Participating, nonparticipating or participating with a cap on participation
- Dividends
  - Cumulative/noncumulative/only if declared
  - Pro rata with common stock dividends
- Anti-dilution protection for below-investment-price future financings
  - Weighted average
- Pro Rata preemptive rights

Key Deal Terms – Governance/Management

- Board composition
  - Founders; majority of Common Stock; those then providing services; CEO director
  - Directors elected by Preferred Stock; designated by lead investor(s)
  - Directors elected by Preferred and Common Stock voting together; independent directors
- Board observers
  - Can reduce the need for Preferred Directors; no fiduciary duties
  - Can result in too many voices in the room
- Voting rights/protective provisions
  - Threshold: veto rights vs. logistical difficulty of obtaining consent
  - Protective Provisions:
    - Preferred Stock: fundamental actions; actions that affect the Preferred Stock differently (and in later rounds, series-by-series votes)
    - Preferred Directors: operational actions that can affect the Preferred Stock
- Management/employee benefits and incentives
  - Are the appropriate management team and other employee agreements, retention, vesting, incentive and employee benefit provisions, in place?
- Amendment Provisions
  - Avoid back-door veto

Key Deal Terms – Exit/Liquidity Matters

When/how can equityholders sell, and should there be any limitations?

- Drag-along provisions
  - Trigger
  - Exceptions
- Registration rights
- Broad transfer restrictions
- ROFR and Co-Sale
  - Will this apply to only Common Stock? Only certain Common Stock?
  - Will the right be held by only Preferred Stock? Only certain Preferred Stock?
- Redemption rights
- Rights of First Refusal/Offer/Notice in favor of lead investors?

VENTURE FINANCING TRENDS

Venture Financing Trends

Increased participation by strategics/CVCs

Shift from company-favorable terms to investor-favorable terms slow to materialize

VCs focused on servicing existing portfolios during COVID-19

Global recovery in total deal value following initial COVID-19 fall

Increase in investment in late-stage companies, decrease in investment in early-stage companies (investors cautious about early stage-companies)

Investors focused on path to profitability (even in long-term)

QUESTIONS?

Biography

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Douglas E. Kingston counsels clients on a wide variety of business law matters, focusing on mergers and acquisitions (M&A), venture capital, and financing transactions. He represents entrepreneurs, startup and emerging growth companies, as well as privately held companies, through their entire life cycle, including start-up matters, equity and debt financings, corporate restructurings, and sale transactions. Douglas has represented clients across numerous industries, including beverage distribution, pharmaceutical, medical device, digital health, consumer products, technology, data management, energy, and fintech. In addition, he serves as a counselor to privately and publicly held companies on a wide variety of general corporate matters.

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Lindsay R. Mozdziock is part of a team that focuses on mergers and acquisitions, financing, joint ventures, spinoffs, and strategic alliances. Other areas of work involve restructuring, tax, and securities, including public and private equity and debt offerings. She advises clients ranging from Fortune 500 companies and investment banks to emerging market companies.

Before joining Morgan Lewis, Lindsay clerked for Judge Diana Gribbon Motz of the US Court of Appeals for the Fourth Circuit. Her clerkship experience included working on *N.C. State Conference of the NAACP v. McCrory*, a major voting rights case in North Carolina.

Lindsay received her J.D., summa cum laude, and her M.B.A., from the University of Pennsylvania Law School and the Wharton School. While in law school, Lindsay served as co-chair of the Penn Law Women's Association, on the board of the *University of Pennsylvania Law Review*, and as a teaching assistant to Professor Michael Wachter for Corporate Law. She was selected to participate in the Penn Law Supreme Court Clinic 2014–2015, where she contributed to a US Supreme Court briefing for a case involving mortgages and bankruptcy law. In business school, Lindsay was selected as a Nonprofit Board Leadership Fellow and served on the Board of Directors of Legacy Youth Tennis and Education. Prior to attaining her J.D./M.B.A., Lindsay worked on political campaigns for state and federal elections. With the variety of her educational and professional background, Lindsay brings a unique blend of business, law, and political perspectives to serve her clients' needs.

Our Global Reach

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Latin America
Middle East
North America

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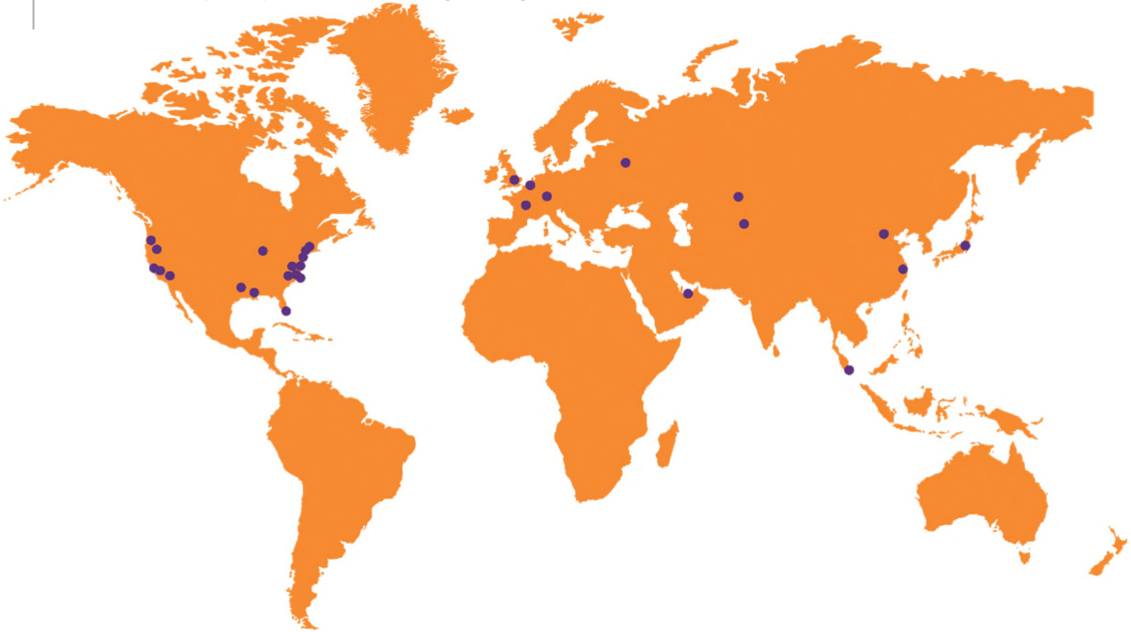
New York
Orange County
Paris
Philadelphia
Pittsburgh
Princeton
San Francisco
Shanghai*
Silicon Valley
Singapore
Tokyo
Washington, DC
Wilmington



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