



Morgan Lewis

SILICON VALLEY

STARTUP AND GROW SERIES

**Making the Most of Your Round –
Preferred Stock Financing Options**

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Presenters



E. John Park



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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

An aerial photograph of a city, likely San Jose, California, showing a dense urban area with numerous buildings, roads, and green spaces. In the background, there are rolling hills and mountains under a clear blue sky. The text "OPTIONS FOR EARLY-STAGE FINANCING" is overlaid in large, bold, white capital letters across the upper portion of the image.

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

An aerial photograph of a city, likely San Jose, California, showing a dense urban area with numerous buildings, roads, and green spaces. In the background, there are rolling hills and mountains under a clear blue sky. The text "PREFERRED STOCK FINANCING: KEY DEAL TERMS" is overlaid in large, bold, white letters on the left side of the image.

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

An aerial photograph of a city, likely San Jose, California, showing a dense urban landscape with numerous buildings, roads, and green spaces. In the background, there are rolling hills and mountains under a clear blue sky. The text "VENTURE FINANCING TRENDS" is overlaid in large, bold, white capital letters on the left side of the image.

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?

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Biography



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E. John Park focuses his practice on debt and equity offerings, public securities offerings, recapitalizations, and mergers and acquisitions (M&A). He assists clients at every stage of the business cycle, from initial company formation, venture capital financings, and M&A, to initial public offerings (IPOs), public company reporting, and general corporate counseling. In addition, John represents acquirers and targets in public-private and private-private business combination transactions.

Biography



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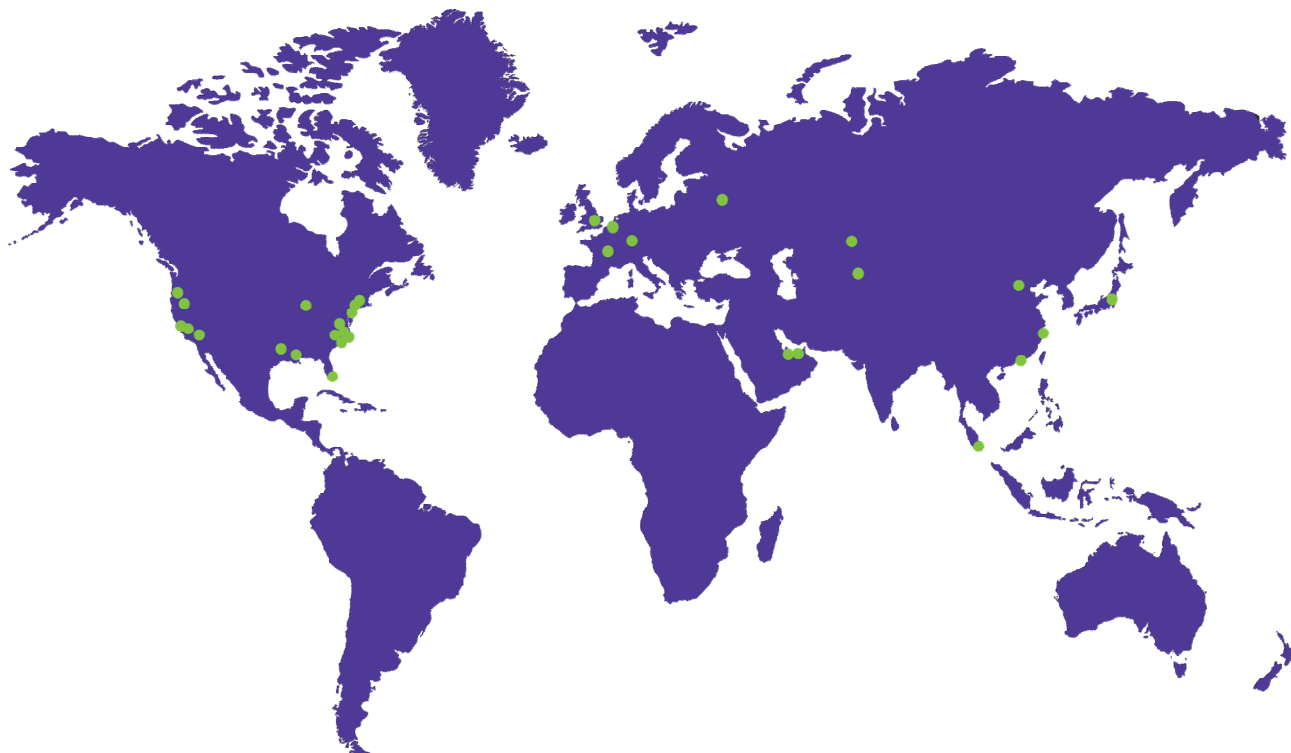
Richard M. Lee represents high-tech and life sciences companies throughout their life cycle, with an emphasis in mergers and acquisitions. Additionally, Richard advises venture capital and corporate VC clients in structuring and implementing investments in emerging companies.

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