PREPARING A TERM SHEET FOR YOUR ANGEL ROUND

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Introduction

Most of the funding for early stage ventures does not emanate from broker-dealer led private placements. Instead, it comes from private individuals commonly referred to as "angels." Whether these angels are "friends and family" or a wealthy stranger, it is important that the investment be structured in a manner that meets the legitimate needs of the investor and the company and does not adversely affect a subsequent investment by a venture capital firm or corporate strategic investor. It is also important for company management to consider that any pro-investor rights or terms, once granted to the angel investors, will become the baseline upon which subsequent investors will seek to add.

The most straightforward structure for an angel investment is a sale of common stock. While a sale of common stock in the angel round is the most simple structure and often most desirable from the perspectives of both the founding common stockholders and future investors, it creates issues with respect to stock option pricing (i.e., the sale of common stock establishes fair market value for future ISO grants) and subjects the angel investor to a greater risk of diluting from future stock issuances by the Company. As a result, unless the angel valuation is so favorable that a subsequent lower priced round is unlikely, most sophisticated angels (especially when capital markets are as tight as they are now) will not purchase common stock, but rather will insist on structuring their investment in a manner that affords the angel greater protection and the possibility of a higher return on its investment.

Two common structures are a sale of simple, convertible preferred stock and a sale of convertible promissory notes (commonly known as a "bridge loan").

Sale of Preferred Stock Structure

Aside from determining the valuation (discussed below), the most important aspect of structuring a sale of preferred stock is determining the preferred stock's rights and preferences associated with liquidation, conversion, dividends, redemption and voting.

Liquidation

In its most basic form, preferred stock affords its holder a preference (in relation to the holders of the common stock) to receive company assets in the event of a liquidation of the company or the payment of dividends. In other words, the holder of preferred stock is entitled to be repaid its original purchase price before any of the company's assets are distributed among the holders of the common stock. This "liquidation preference" can take a variety of forms. When capital markets are tight, an investor may require that it receive some multiple of its original investment before the company's assets are distributed among the common stockholders. Since this will create an expectation of an increased liquidation preference in subsequent rounds, it is usually better in an angel round to simply agree upon a lower valuation and maintain a "1x" liquidation preference.

In some deals, the holders of the preferred stock negotiate the right to participate in the distribution to the common stockholders after receiving their full liquidation preference. Preferred stock with this feature is known as "participating preferred." The participation is often subject to a cap. In other words, the preferred stockholder first receives its liquidation preference and then participates in the distribution to the common stockholders, but only until the investor receives some agreed-to multiple of its original investment. Again, once this feature is introduced, it will likely remain in subsequent rounds. Thus, if an angel investor insists upon participating preferred for a $500,000 investment and the company later raises $10 million through the sale of participating preferred, the angel will usually receive less money upon a sale of the company than if there was no participation feature.

Conversion

Customarily, the preferred stock to be sold to an angel will be convertible into common stock of the company. The term sheet should provide the ratio upon which the conversion is to be based. A familiar formulation provides that the total number of shares of common stock into which the shares of preferred stock may be converted is determined by dividing the original per share purchase price paid for the stock by a "conversion price." Typically, the conversion price will be initially equal to the original purchase price, resulting in an initial conversion ratio of one-for-one. Where the investor is to be given anti-dilution protection, this protection will take the form of an adjustment to the conversion price for future issuances of additional equity securities at a purchase price below the then applicable conversion price. The conversion price is most often adjusted on a "weighted average" basis. A weighted average adjustment results in a reduction of the conversion price based upon the new stockholder's proportionate investment, as opposed to a full ratchet adjustment (which, simply put, adjusts the conversion price downward to equal the per share purchase price of the additional equity security whose issuance necessitated the adjustment).

Redemption

If the preferred stock is subject to or has the benefit of redemption rights at some point in the future, the term sheet should describe when and under what circumstances a redemption could occur. A redemption feature prevents management from simply drawing a salary indefinitely as the business grows, while investors receive nothing. A redemption right time period should be after the time the company reasonably expects an exit, and is most commonly five (5) years from the date of investment, except in biotechnology companies where the period is virtually always longer.

Voting/Control

Angel investors have a legitimate right to input in the decision making process and often have the right to nominate a member of the board of directors prior to a venture round. The angels may also negotiate certain "veto" rights over issues such as a sale of the company or the next financing round, which is fine, so long as these rights terminate upon the first venture round or the angels vote alongside the venture capitalists as a single class in exercising these rights.

Bridge Loan Structure

In certain situations, such as where there is significant uncertainty (or disagreement) as to the company's valuation, it may make sense to structure the investment as a bridge loan. This type of loan is referred to as a "bridge" loan because it bridges the gap between the time of the investment and the company's planned future venture capital round.

Promissory Note

In the bridge loan scenario, the investor does not immediately become a stockholder of the company. Rather, the investor purchases and is issued a promissory note which matures at a future date (one year is typical). Customarily, the promissory note is convertible into shares of the same class and series of stock to be issued by the company at its next anticipated venture capital financing. In some instances, the loan will provide that in the event the next venture capital closing does not occur prior to the maturity date, the note can be converted into common stock of the company at a relatively low valuation. This requires the company and the angel investor to agree upon the valuation of the common stock at which the note will convert. In situations where one of the reasons for structuring the transaction as a bridge loan was the inability to decide upon a valuation, this could be problematic. In addition, the setting of a future valuation for the conversion may be perceived as setting a ceiling for the anticipated venture capital valuation.

Security

Unlike a promissory note issued to a bank, a bridge note is usually not secured by the company's assets. This is primarily for two related reasons. First, the start-up company seeking the bridge loan typically does not have hard assets of the type that could easily be foreclosed on and sold by an angel investor. Second, a secured promissory note issued to a bank is generally not convertible into the company's stock. The ability of the lender (in this case, the angel) to convert the bridge note into equity (thus increasing the potential upside) compensates the lender for the lack of security.

Interest

We generally recommend that interest on the note be paid in cash for two reasons. First, the investor will be taxed on the investment in the year paid, regardless of whether it is paid in cash or converted to stock. Also, it is complicated at the time of the venture capital closing to calculate the conversion rate until you know the exact closing date, and the venture capital calculation is usually based on a specific number of shares outstanding on that closing date.

Warrant Coverage

Often, the angels purchasing the bridge notes will want to receive a discount on the shares into which their notes will be converted as an enticement or "sweetener" for the angels' willingness to invest prior to the venture capitalist, thus taking additional risk. Since a preferred stockholder’s liquidation preference is typically pegged to its original purchase price for such shares, a “discount” to the purchase price of the preferred stock will result in either the angels and the venture capital investors having different liquidation preferences in the same series of stock or the angels having a liquidation preference in excess of their investment amount. In order to avoid that result, we generally recommend that any such “sweetener” or discount be given to the angel in the form of a warrant to purchase the company’s stock. It is worth noting, however, that when the venture capitalist determines the fully diluted number of outstanding shares in performing its valuation, it will consider the shares that are issuable upon exercise of the warrant to be outstanding, while the warrant exercise price is not paid. Thus, we generally recommend issuing fewer warrants at a low exercise price and requiring those warrants to be exercised at the closing of the first venture capital round.

Decisions by the Noteholders

Where the bridge note will be issued to more than one angel, it is useful to make sure that any decisions or elections which may be made by the holder of the note (i.e. whether to declare and event of default, or whether to elect conversion in certain situations) are made by a vote of the noteholders as a group. A common formulation would require the vote of those persons holding 51% of the outstanding principal amount due under the bridge notes. Where there is more than one noteholder and the bridge notes are secured (as indicated earlier, rare for angel rounds), it is beneficial to have the noteholders appoint an agent or trustee who can make decisions for the group and exercise rights with respect to the security interest.

Valuation and the Current Economic Climate

As mentioned above, one of the most difficult terms to agree upon is the valuation. Custom, the current economic climate, and how “hot” the company is, rather than detailed financial analysis, will generally determine the final valuation. In the current economic environment, many angels are preferring the bridge loan structure because it relieves them of attempting to arrive at a valuation and allows the angel to rely upon the judgment of the subsequent venture capital investor. An additional benefit to the angel investor of purchasing a note rather than stock is that, as a noteholder, the angel is in a better position than a preferred stockholder should the company end up in bankruptcy (although, at that point, there is generally nothing for creditors to divide).

From the company’s perspective, it may also be desirable to defer a determination of valuation because it avoids arriving at a valuation that is either too low or too high at the time of the angel investment. While it may not appear so at first glance, an excessive valuation in the angel round can be bad for a company in that it may result in the subsequent venture capital round being a “down round”. In addition to complicating the round, a down round can have a negative impact on employee morale and the company’s momentum, as well as investment interest by some venture capitalists.

Conclusion

Thus, the company and the angel investors should both be primarily concerned with the same issue: structuring the angel investment transaction in a way that does not unnecessarily complicate or hinder a subsequent investment by a venture capital firm. While every deal is struck based on different facts, desires and needs of the investor and the company, certain basic tenets are common to all angel investments. Participants will inevitably negotiate the terms considering primarily their own self-interest, but they should keep in mind that their primary self-interest is being part of a growing, successful company structured to maximize its future ability to raise funds.

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