Convertible Note Financing Term Sheet (Seed-Stage Start-Up)

A Lexis Practice Advisor® Form by
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FORM SUMMARY

This form is a financing term sheet for convertible notes issued in connection with the seed-stage financing of a start-up company. A convertible note is a loan from the investor to the company that converts to stock upon a preferred stock financing that meets certain conditions. This form includes practical guidance, drafting notes, alternate clauses, and optional clauses.

Start-ups use seed-stage financing to raise operational capital for a period of 12-24 months in which they attempt to build their product and test the market. A convertible note is the most common instrument to implement seed-stage financing. This form sets forth the terms of a proposed convertible note financing. The terms of the note described in this term sheet are generally market, with preference given to be borrower-friendly in instances where provisions are fluid in the marketplace.

For a further discussion of convertible notes as well as other forms of start-up financing, see Seed Financing Overview. For a form of convertible note to be used in this context, see Convertible Note (Seed-Stage Start-up).

THIS SUMMARY OF TERMS SUMMARIZES THE PRINCIPAL TERMS OF THE PROPOSED FINANCING OF [COMPANY] (THE *"COMPANY"*) THROUGH THE ISSUANCE OF CONVERTIBLE PROMISSORY NOTES. THIS SUMMARY OF TERMS IS FOR DISCUSSION PURPOSES ONLY. EXCEPT FOR THE SECTION ENTITLED "CONFIDENTIALITY," THERE IS NO OBLIGATION ON THE PART OF ANY NEGOTIATING PARTY UNTIL THE DEFINITIVE DOCUMENTS ARE SIGNED BY ALL PARTIES. THE TRANSACTIONS CONTEMPLATED BY THIS SUMMARY OF TERMS ARE SUBJECT TO THE SATISFACTORY COMPLETION OF DUE DILIGENCE. THIS SUMMARY OF TERMS DOES NOT CONSTITUTE EITHER AN OFFER TO SELL OR AN OFFER TO PURCHASE SECURITIES.

[COMPANY] CONVERTIBLE NOTE

FINANCING

Drafting Note to Convertible Note Financing: This is a formal term sheet for a convertible note issuance in connection with a seed-stage financing. The process of a seed-stage financing does not necessarily include a formal term sheet. One of the benefits of convertible notes is that they are relatively straightforward. Company counsel (or even the founders of the start-up if there is not yet counsel) may draft the convertible note documentation as a first step in the process, without a formal term sheet and based only on a summary of key terms (e.g., valuation cap, discount, and maturity date) agreed to by the parties. Although it is customary to forego a term sheet, in some cases it may be required if the parties need to negotiate certain terms. It can be advantageous to use a term sheet for the company to easily summarize the terms of the notes for potential other investors purchasing a convertible note.

The note described in this term sheet is neither secured nor subordinated to senior debt, as neither of these terms are typical in convertible promissory notes issued in seed financings. This means that in a liquidation of the company, the note would receive payment prior to any payments to stockholders (i.e., equity investors), but the note investors cannot foreclose on the company's assets since the note is unsecured.

<u>SUMMARY OF TERMS</u>

Amount of Financing: $[__]

Alternate Clause to Amount of Financing:

Amount of Financing: $[__], including $[___] from Lead Investor.

Drafting Note to Alternate Clause to Amount of Financing: You may include this alternate clause if there is a lead investor for the note financing. It identifies the amount of the total financing provided by the lead investor, which is typically a significant portion.

Type of Security: Convertible promissory notes (the "***Notes***") having the terms described below.

Closing: The initial closing of the sale of the Notes will occur as soon as practicable.

Drafting Note to Closing: Companies, investors, and their lawyers typically understand the mechanics of convertible notes. As a result, the total time from start of the process to closing can be very short. For example, a convertible note financing in its simplest form may take only 1-2 weeks. There are also relatively low legal fees, which is another advantage of this form of financing.

Interest Rate: [___] percent ([___]%) per annum.

Drafting Note to Interest Rate: This is typically 4-6%.

Optional Clause to be added after Interest Rate:
Lead Investor: **[ ]**

Drafting Note to Optional Clause to be added after Interest Rate: Include if there is a lead investor in the financing. A lead investor typically negotiates and deals with the company on behalf of itself and the other investors.

Maturity: Unless earlier converted, the entire balance under the Notes shall be due and payable upon (a) [ ] months from the initial closing or (b) the time at which the balance is due and payable upon an Event of Default (as defined below) (such earlier time, (the "***Maturity Date***").

Drafting Note to Maturity: The maturity date is typically 12-24 months from the date of issuance of the note.

No Prepayment: Except with regard to the conversion of the Notes, the Company may not pay any of the balance under the Notes before it becomes due.

Drafting Note to No Prepayment: This term sheet does not provide for prepayment, as investors in convertible note financings generally will not permit prepayment, since a prepayment could prevent them from converting the note in a financing, merger or asset sale.

Conversion:

Conversion in Next Financing. Upon the Company's next sale of its preferred stock in a single transaction or in a series of related transactions, in each case occurring on or before the Maturity Date, for an aggregate gross purchase price paid to the Company of no less than [One Million Dollars ($1,000,000)] (excluding the principal amount of and accrued interest or any other amounts owing on all Notes converted in such sale) (the "***Next Financing***"), the entire balance then outstanding under each Note shall automatically be cancelled and converted into shares of the Company's capital stock at a conversion price equal to the lower of (i) [__]% of the price per share agreed to in the Next Financing or (ii) the quotient obtained by dividing (A) $[VALUATION CAP] by (B) the number of shares of Common Stock of Borrower outstanding immediately prior to the Next Financing(the "***Conversion Price***"). The total number of shares of capital stock that a holder of a Note shall be entitled to receive upon conversion of such Note shall be determined by dividing (x) the principal and interest outstanding under the Note by (y) the Conversion Price (the "***Total Number of Shares***"). The Total Number of Shares shall consist of (1) that number of shares of Preferred Stock issued in the Next Financing obtained by dividing (A) the entire principal and interest outstanding under the Note by (B) the price per share agreed to in the Next Financing (the "***Number of Preferred Stock***") and (2) that number of shares of Common Stock equal to the Total Number of Shares minus the Number of Preferred Stock.

Conversion following Maturity Date. After the Maturity Date, the Investor shall have the ability to convert the Note into shares of the Company's [common/preferred] stock.

Drafting Note to Conversion:

Threshold for new financing. This term sheet sets one million dollars as the threshold size for the next financing. Two million dollars is often used as the threshold, but one million dollars provides the borrower with more flexibility, which is why that amount is included here.

Conversion price. There are several ways to determine the conversion price of a convertible note. The most typical formulation is that the conversion price is the lower of an agreed cap upon the company prior to the next financing (i.e., a valuation cap) and a discount to the new issuance price (usually 15-25% of the share price in the next financing). Other ways to determine the conversion price include (i) the price paid in the next financing without any discount (though this is rarely seen, since it provides no incentive for the note holders to invest their capital earlier in the company's life cycle), (ii) only the discount to the next financing share price, or (iii) only the valuation cap.

Total number of shares. The formulation of the total number of shares contemplates that the noteholder receives a number of shares of preferred stock sufficient to align its liquidation preference with the amount of capital it invested pursuant to the note. The remainder of the shares to be issued as a result of the discount and/or valuation are issued in common stock. This formulation is generally understood and accepted within the angel investor community.

Optional Clause I to be added after Conversion:
Change of Control: If the Company completes a change of control transaction before the payment or conversion of the entire balance under each Note and prior to the Maturity Date, then upon the closing of such change of control transaction, the holder thereof shall be entitled to be repaid the entire balance then outstanding plus an amount equal to [100]% of the original principal balance of such Note.

Drafting Note to Optional Clause I to be added after Conversion: A prepayment upon a change of control benefits the noteholder, rather than the borrower. For this reason, it is optional to include a provision for change of control when the company is drafting the note. It is, however, common in convertible notes and so you may want to add. This additional payment (kicker) is optional, but common in convertible note terms. A 50-100% extra payment is typical.

Optional Clause II to be added after Conversion:
Change of Control: If the Company completes a change of control transaction before the payment or conversion of the entire balance under each Note and prior to the Maturity Date, then upon the closing of such change of control transaction, the holder thereof shall be entitled to be repaid the greater of (a) the entire balance then outstanding plus an amount equal to [100]% of the original principal balance of such Note and (b) the amount that would be payable in connection with such Change of Control with respect to that number of shares of Common Stock issuable if the entire Balance then outstanding was converted immediately prior to the consummation of such Change of Control into that number of shares of the Company's Common Stock determined by dividing (x) the entire Balance then outstanding by (y) the quotient obtained by dividing (A) [VALUATION CAP] by (B) the outstanding capitalization of the Company.]

Drafting Note to Optional Clause II to be added after Conversion: This is a more investor-friendly alternative definition of Change of Control.

Events of Default: The entire balance under the Notes shall become due and payable upon the occurrence of any of the following (each, an "***Event of Default***"): (a) the Company fails to make any payment under the Notes when due; (b) a receiver is appointed for any material part of the Company's property, the Company makes a general assignment for the benefit of creditors, or the Company becomes a debtor or alleged debtor in a case under the U.S. Bankruptcy Code or becomes the subject of any other bankruptcy or similar proceeding for the general adjustment of its debts or for its liquidation; (c) the Company breaches any of its material obligations under the Notes or any other financing document and does not cure such breach within 20 days after written notice thereof to the Company; and (d) the Company's Board of Directors or stockholders adopt a resolution for the liquidation, dissolution or winding up of the Company.

Drafting Note to Event of Default: Include the consummation of a change of control as an additional event of default if you have included a change of control definition.

Documentation:	The Notes will be issued pursuant to a series of Convertible Promissory Notes. The terms of each Note may be amended or waived with the written consent of the Company and the holders of Notes representing at least a majority of the aggregate principal balance under all the Notes then outstanding.

Drafting Note to Documentation: Grouping the outstanding notes together in a series provides for an easier amendment process (i.e., just consent from the majority of the outstanding principal and the borrower) if the maturity date needs to be extended or the terms of the conversion changed in connection with a financing.

Confidentiality:	The terms and conditions of this Summary of Terms, including its existence, shall be confidential information and shall not be disclosed to any third party without the consent of the Company[and [Investor]], except that the Company and the investors may disclose the terms and conditions described in this Summary of Terms to their respective officers, directors, partners, employees, attorneys and other advisors, provided that such persons agree to the confidentiality restrictions contained herein. If any party determines that it is required by law to disclose information regarding this Summary of Terms, it shall, a reasonable time before making such disclosure or filing, consult with each other party regarding such disclosure or filing and seek confidential treatment for such portions of the disclosure or filing as may be reasonably requested by the other party.

Drafting Note to Confidentiality: You may make the confidentiality provision reciprocal or may make it so that only the Company can consent to disclosure.

Except for the Section entitled “Confidentiality,” this Summary of Terms and the proposed terms set forth above do not constitute a binding agreement or commitment of the investors, the Company or any of their affiliates. Any agreement or commitment will only be contained in definitive agreements (containing the usual representations, warranties, conditions and covenants for this type of transaction) to be negotiated, executed and delivered, if at all, after the completion of appropriate due diligence and approval of the Board of Directors or the Company. Either party to the negotiations may terminate negotiations at any time for any reason and each party will bear its own expenses if a definitive agreement is not signed.

The parties to this Summary of Terms acknowledge their agreement to the terms contained herein by signing below:

[Company]	**[Investor]**
By: ______________________________	By: ______________________________
Name: ____________________________	Name: ____________________________
Title: _____________________________	Title: _____________________________
Date: ___________________________	Date: ___________________________

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Kristine M. Di Bacco represents emerging technology companies primarily in the consumer Internet, e-commerce, FinTech, digital health, consumer hardware and software sectors.

Her practice includes a broad range of corporate transactional matters, including the formation of new start-up companies, venture capital financings, mergers & acquisitions and public offerings. Kristine provides clients with practical and thoughtful advice to help solve their business and legal issues, and assists clients in structuring, negotiating and closing business transactions quickly and effectively. She also represents and advises leading incubators, angel investors and venture capitalists investing in technology companies.

Kristine earned her J.D. from McGill University Law School and her MBA from Cornell University.

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Doug Sharp is an associate at Fenwick & West. He counsels established and emerging technology companies and investors in a variety of corporate matters, with an emphasis on start-up financings, M&A and strategic transactions. His emerging company clients span the technology sector and include innovators in cybersecurity, aerospace, virtual and augmented reality, enterprise software and social media.

Doug earned his J.D. from Stanford Law School.

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