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Negotiating and Structuring Convertible Note Financing: Discount Rates, Valuation Caps, Conversion Triggers

Due Diligence, Determining Priority vs. Other Creditors and Equity Holders

WEDNESDAY, AUGUST 14, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Kristine M. Di Bacco, Partner, **Torys**, Toronto

Josh Teichman, Attorney, **Torys**, Toronto

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 1**.

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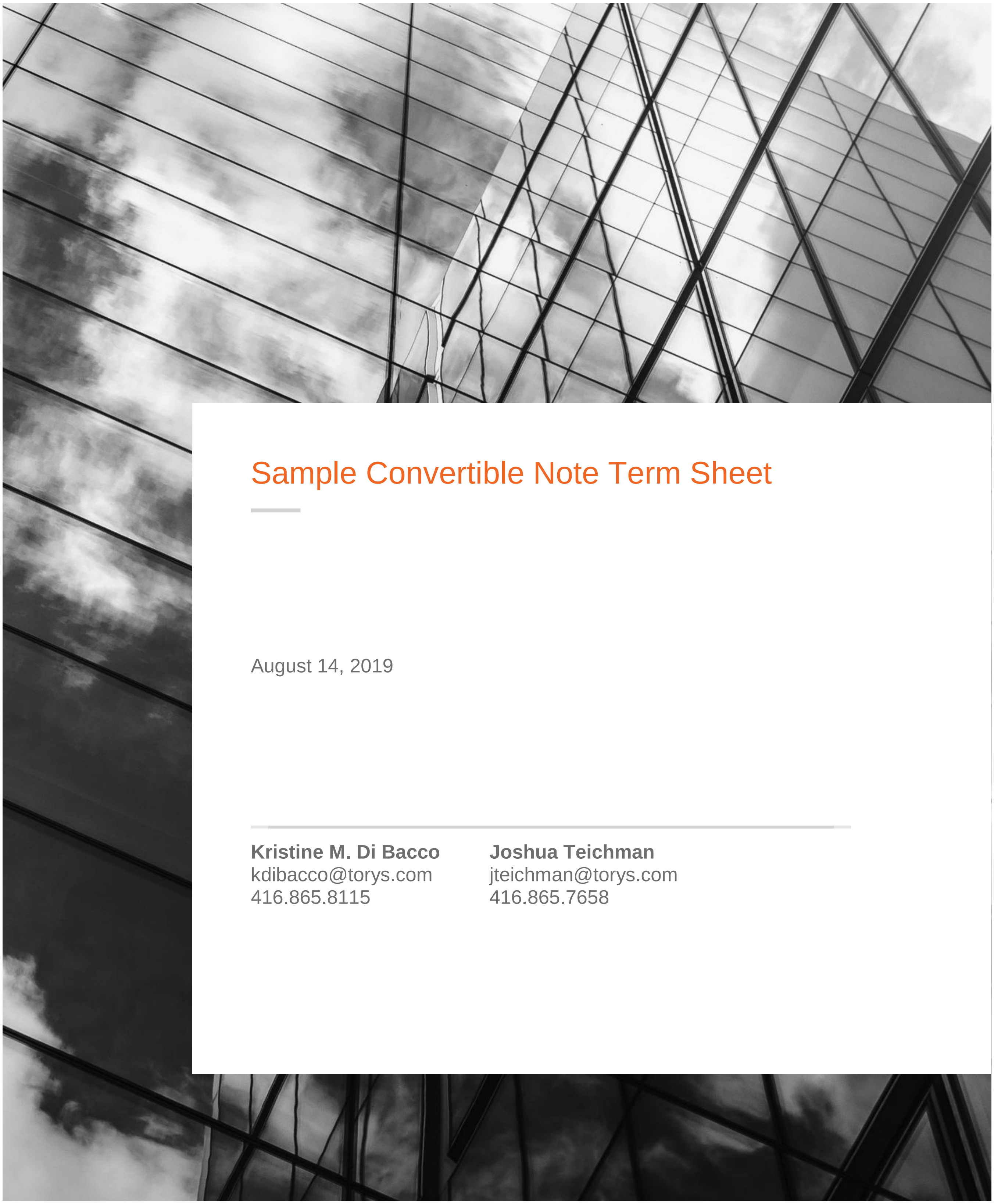

Sample Convertible Note Term Sheet

August 14, 2019

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INTRODUCTION

This sample term sheet for a convertible promissory note is designed to be used for the financing of a seed-stage start-up company. It includes a number of fields that need to be completed for any given financing, as well as optional and alternate language to be included in appropriate circumstances. This form is not intended to be a substitute for proper legal advice and should not be construed as such.

For further information, guidance and to obtain a copy of the convertible note that accompanies this sample term sheet, please reach out to a member of our Emerging Companies and Venture Capital Group at https://www.torys.com/expertise/services/emerging-companies-and-venture-capital.

THIS TERM SHEET SUMMARIZES THE PRINCIPAL TERMS OF THE PROPOSED FINANCING OF [COMPANY NAME] (THE "*COMPANY*") THROUGH THE ISSUANCE OF CONVERTIBLE PROMISSORY NOTES. THIS TERM SHEET 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 TERM SHEET ARE SUBJECT TO THE SATISFACTORY COMPLETION OF DUE DILIGENCE. THIS TERM SHEET DOES NOT CONSTITUTE EITHER AN OFFER TO SELL OR AN OFFER TO PURCHASE SECURITIES.

[COMPANY NAME]

CONVERTIBLE NOTE FINANCING

TERM SHEET

Amount of Financing:	$[Aggregate Round Size].
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. Additional closings may be held at the option of the Company until [Date][1], as will be further described in the Purchase Agreement (as defined below).
Interest Rate:	[Interest Rate Number][2]% per annum.
Maturity:	Unless earlier converted, the entire balance under the Notes shall be due and payable upon the earlier of (a) [Term][3] [years/months] from the date of 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**").
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.
Conversion:	Conversion in Qualified 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 $[Qualified Financing Amount][4] (excluding the principal amount of and accrued interest or any other amounts owing on all Notes and other convertible securities converted in such sale) (the

1 Typically 90-180 days.

2 Typically 2-6%.

3 Typically 12-24 months.

4 Typically ~$2M.

“**Qualified Financing**”), the entire balance then outstanding under each Note shall automatically be converted into shares of the Company’s capital stock (the “**Note Shares**”) to be issued simultaneously with the issuance and sale of the Company’s preferred stock in the Qualified Financing at a conversion price equal to the lesser of (i) [100% *less* the Discount Rate]% of the lowest per-share selling price in the Qualified Financing; and (ii) the price per share obtained by dividing (A) $[Valuation Cap] by (B) the number of common stock equivalents of the Company outstanding as of 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 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 the Notes or other convertible securities) (such lower price, the “**Conversion Price**”).

[NTD: If the note will convert into a shadow class of Preferred Stock, include the following paragraph.]The Note Shares will have identical rights, privileges, preferences and restrictions as the shares of capital stock issued to new money investors in the Qualified Financing, other than with respect to (i) the per share liquidation preference; and (ii) the per share dividend, in each case, which will reflect the Conversion Price.

[NTD: If the note will convert into a combination of Preferred Stock and Common Stock, include the following paragraph.] 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 Qualified Financing obtained by dividing (A) the entire principal and interest outstanding under the Note by (B) the price per share agreed to in the Qualified 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.

[NTD: If the note holder will have the option to convert on a Non-Qualified Financing, include the following paragraph.]Conversion in Non-Qualified Financing. In the event the Company consummates, prior to the Maturity Date, an equity financing that is not a Qualified Financing (a “**Non-Qualified Financing**”), then at the closing of the Non-Qualified Financing all principal and accrued interest under the Notes shall, at the option of each Note holder, convert into the number of shares of Preferred Stock issued in the Non-Qualified Financing determined by dividing the principal and accrued interest under the Notes by the price per share paid by the investors in the Non-Qualified Financing.

[NTD: If the holder of the Note will have the right to convert the Note into equity at Maturity, include following paragraph.] Conversion following Maturity Date. In the event that any of the Notes remain outstanding on the Maturity Date, at the option of the holder of the Note, the then outstanding principal balance of the Note and any unpaid accrued interest shall convert into Common Stock at a conversion price equal to the quotient resulting from dividing $[Valuation Cap] by the number of outstanding shares of Common Stock 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 the Notes or other indebtedness).

Change of Control:

[NTD: If the holder will only receive a change of control premium, include the following paragraph.]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 an amount equal to (i) original principal balance of such Note and all accrued and unpaid interest due thereon, *plus* (ii) an amount equal to [Change of Control Premium][5]% of the original principal balance of such Note.

[NTD: If the holder will receive the better of a change of control premium and the conversion amount, include the following paragraph.]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 (i) the original principal balance of such Note and all accrued and unpaid interest due thereon[, *plus* an amount equal to [Change of Control Premium]% of the original principal balance of such Note], and (ii) 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

[5] Typically 50-100%.

shares of 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 (excluding all shares of Common Stock reserved and available for future grant under any equity incentive or similar plan of the Company).

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.
Documentation:	The Notes will be issued pursuant to a Note Purchase Agreement (the "***Purchase Agreement***") to be signed by the Company and each of the investors. The terms of the Purchase Agreement and 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.
Confidentiality:	The terms and conditions of this Term Sheet, including its existence, shall be confidential information and shall not be disclosed to any third party without the consent of the Company, except that the Company and the investors may disclose the terms and conditions described in this Term Sheet 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 Term Sheet, 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.

Except for the Section entitled "Confidentiality", this Term Sheet 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 Company's Board of Directors. 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 Term Sheet acknowledge their agreement to the terms contained herein by signing below:

[COMPANY NAME]

By: ________________________________
Name:
Title:

[INVESTOR #1 NAME]

By: ________________________________
Name:
Title:

[INVESTOR #2 NAME]

By: ________________________________
Name:
Title: