Locust Walk Institute Webinar Series

Life Science Financing Term Sheet Review

Final Q&A

Question: Are there ever antidilution rights for founders rather than institutional investors?

Antidilution rights are not only limited to investors. However, antidilution as we refer to it in the webinar deals with the conversion ratio of the preferred stock to common stock in the company's Certificate of Incorporation. Since most founders hold common stock, they are already holding the most basic form of stock so there is no conversion mechanism to help prevent dilution. Founders therefore have two ways of addressing this:

1. Hold a class or series of stock other than common stock. A founder could hold Founder Preferred or a separate class of common stock which otherwise looks exactly like common stock except it has antidilution rights. However, this structure is usually frowned upon by institutional investors since it makes the cap table more complex and the goal, especially early on, is to have as simple a capitalization structure as possible. The presence of a dual class structure of common stock or founder preferred could make it more difficult to raise capital.
2. The second and much more common way founders or management receive some sort of antidilution right is having a contractual right to receive additional shares in certain circumstances. The CEO could, for instance, negotiate that a warrant is issued following the next round of financing that ensures that his or her fully-diluted ownership of the company equals a certain percentage. After the conditions in the contract are satisfied, however, no additional shares need to be issued and the founder/CEO could be subject to dilution at that point.

Question: What happens if the VCs have a majority and don't respect the voting rights in the charter or certificate of incorporation and do what they want despite the governance documents?

Voting thresholds contained in the Certificate of Incorporation trump any contractual thresholds, such as what is in a Voting Agreement or Investors Rights Agreement. The Bylaws then govern how votes may be taken at the board of directors and what is needed for approval. If a vote doesn't meet the thresholds contained in the Charter and the process contained in the Bylaws, then the action is usually invalid. Members of the board also have a fiduciary duty to all of the stockholders, especially minority stockholders, not just the stockholder(s) who nominated him or her. Regarding any specific issues you may be having in your own company, these matters are always case-by-case dependent and if you feel your situation warrants it, we would recommend engaging qualified legal counsel to determine what actions, if any, are available.

Question: How can founders guarantee their information rights?

Information rights are a contractual right to certain financial and other information of the company typically contained within the Investors Rights Agreement. Since it would be a large burden to the company for every investor to get these reports, the Investors Rights Agreement will have a definition for a "Major Investor" typically based on share ownership that sets the threshold for who gets information rights. Since it is contractual, the definition of Major Investor can be drafted however the parties want and can certainly be done in a way to capture certain individual investors, such as Founders.

Question: What rights do you see strategic investors (specifically biopharma companies (not their VC arms) seeking? How might this differ from traditional VCs? For instance - biopharmas are likely less interested in certain controls over management and BOD.

In this response, when I refer to a "strategic investor" I am referring to a company making an investment into a company as part of a broader strategic transaction as opposed to as part of a corporate venture fund. Corporate venture funds now behave very similarly to institutional investors in terms of what they ask for in a financing.

In a strategic transaction where the licensor is including an equity investment as part of its purchase price, it is more typical that the equity purchased is the same series of preferred as was most recently sold. This way, the rights of the equity are already settled and there is one less thing to negotiate since there is already enough to negotiate over with the license. If there has been a significant amount of time that has elapsed since the most recent financing and the post-money valuation of the company is too low given the company's current situation, the shares can still be sold at a premium to the original issue price of the preferred stock or a new series can be created that's *pari passu* with the most recent preferred in every way except the Original Issue Price is updated to reflect the investment amount for purposes of the Liquidation Preference and conversion and antidilution calculations.

Now, with the issuance of the additional preferred stock it may be necessary to revisit each of the voting thresholds contained in the Charter and other documents and see what the impact would be to determine if other edits are needed. At this point, it comes down to what matters most for the strategic investor in terms of what actions they want to have a blocking vote on. It is rare for the strategic investor to want to have too large a role in the ongoing governance of the company so they would care about fewer items than an institutional investor or corporate VC. However, while a strategic investor may not require a board seat, they may want board observer rights so they are still informed as to what's happening at the company outside the Joint Steering Committee or whatever else is set up under the license. They may also want something such as a right of first negotiation or a matching right in the event that the company wants to sell itself or its remaining rights in the licensed asset.

Question: So most Series A have participating preferred with no cap. That is very bad for common holders. Does that then extend to Series B and C?

Question: On slide 18, can you elaborate a bit on the difference between A and other rounds (i.e your comment on prevalence in Series A?

Question: Why is it more likely for a Series A investors to participate with common as opposed to investors who are in later rounds of financing?

Question: I had a quick question on the slide for percentage of deals with participating preferred. Is this specific to life science deals or all venture financings regardless of sector?

These questions are very similar so I'll answer them together. It is typical that a Series A investment is fully-participating (i.e. no cap). This is because the Series A investors are typically taking on the most risk for their investment both in terms of probability of success and time to exit so the full participation helps compensate them for that risk beyond just the liquidation preference (which is typically only 1x). It is also true that precedent is a very hard thing to break and once one series of preferred has a certain right it is much more difficult to deny that right to later series. What it comes down to then is the leverage the company has in its negotiation for the Series B, C, etc. and what the return profile looks like for each of those series of preferred – all else the same, the Series B is unlikely to accept a "worse" deal than the Series A. However, if the B has a higher liquidation preference than the Series A, for instance, then there is less need for there to be uncapped participation since the return comes from elsewhere.

The terms trends information we presented in the slides was courtesy of CooleyGO, which can be accessed at www.cooleygo.com/trends. The analysis on slide 18 includes both life sciences and technology, but the trends all hold true for life science companies specifically for the reasons already stated above.

Question: Regarding dividends, the difference between "cumulative" and "non-cumulative" is huge. Is one of these currently more "standard" than the other?

Question: On Slide 15 of your deck you referred to dividends and noted that they come in a couple of flavors. Accruing/cumulative vs. "as and when paid". We think most deals and especially west coast deals use the "as and when" paid flavor- but have a limited dataset here and wanted to take your temperature on that.

In most cases for life science companies, dividends are "as and when paid" regardless of geography.   It is fairly aggressive to have an accruing or cumulative dividend since, as one questioner already noted, the accrued or cumulative balance can increase very quickly (and even more quickly if there is any sort of compounding). The reason cumulative dividends are rare in life science companies is because so few of these companies (1) have positive retained earnings in order to pay dividends (a legal requirement) or (2) free cash available that isn't being reinvested into the company. Even larger commercial biotech companies rarely pay dividends and instead reinvest the cash into further drug development.

What is more typical is to say there is a $0.08 dividend (for example) that is paid first whenever a dividend is declared, so the preferred holders would get the first 8 cents per share on whatever amount is declared and then sharing equally with the common in the remaining cash available for distribution.

Question: What % of VC deals typically have a No-Shop/Exclusivity term, and how is this trending? How much does the time period (e.g., 30-60 days) vary?

If a term sheet is being submitted by an institutional investor such as a VC or a corporate venture firm, in nearly all cases it should be expected that there will be some form of No Shop or Exclusivity. Because diligence costs a lot in terms of time and money, few investors would be willing to start this effort without having the protection of knowing that the deal is theirs. Investors also don't like "term sheet shopping" where the term sheet they submit is used to generate better terms from other parties and they are then forced to improve their own offer. So the investor's goal is to get the company under a No Shop as quickly as possible. The exclusivity period is usually around 60-90 days, but it is possible it can be as short as 30 or as long as 120. The length in many cases depends on how much work there is to be done and the status of the current shareholder documents.

<u>Question</u>: How much of a runway is needed for a Series A in your experience and how much of a burn rate is permissible before another Series round is needed

The general rule of thumb is each round of financing should be enough to reach a major milestone in the company's development, which serves as the justification for an increase in the valuation of the company. Because this length of time varies on a company-by-company basis, there is no set time for how long a round of financing should last. We would recommend having at least a year of runway remaining when starting to raise the next round of financing.

<u>Question</u>: What is the rationale for a liquidation preference greater than 1x? If the investors are already getting their money back, isn't that enough? (Slide 17)

The purpose of the liquidation preference is to compensate the investors for making a risky investment into the company. The amount of the liquidation preference is therefore a measure of the risk of the investment and the riskier the investment, the greater the amount the investors are going to ask as a guaranteed first return. In most cases a 1x liquidation preference is enough since, as you pointed out, they are first getting their return of capital. But, for any number of reasons the investors may ask for more than 1x. The most common reason is because if the liquidation preference stack is large enough, the chance of the company having a high enough exit that an investor would ever receive more than his or her liquidation preference goes down (i.e. the chance to participate in the upside with the common) so by asking for a great liquidation preference it at least ensures they get more than their money back. Sometimes it just comes down to the company's current financial position and who has the leverage in the negotiation.

<u>Question</u>: As an early stage investor, what is my best defense against later pay to play funding rounds? (slide 21/22)

The best defense against a future pay-to-play is understanding what the true future funding requirements are likely to be for the company and when you make an initial investment you have enough other cash in reserve (called "dry powder") to maintain your pro rata ownership via the preemptive rights. If you have the cash, you don't have to worry about the consequences of a pay-to-play. Absent that, the best defense is to do good diligence on any new investors before accepting them into the syndicate to try to decide if they are the kind of group that will later try to put in force a pay-to-play.

Question: My company is considering a series A financing round. What are your recommendations for me to maintain maximum control, knowing that I give up some equity?

How much control you will have as the Founder will depend on what terms the investors are willing to give you. At some point, money talks – and money, especially from institutional investors, is never without strings attached. Ultimately, the best way to maintain control is to do your best to lock in a board seat and set voting thresholds in a way that you have a blocking vote on certain actions. However, the investors would have to agree to each of these and there is no guarantee that they will.

Question: As an investor, in what situation would I enforce demand registration rights? It seems that that would have an overall negative impact on my investment if they were not ready to enter the public markets

In general, an investor is unlikely to exercise demand registration rights when the company isn't in a position to be successful as a public company. However, it still is a way to exert some leverage to force the company to do "something" other than the status quo. If a company is in a position to go public but for whatever reason is delaying doing so, then the demand right can be useful. Where demand registration rights are most common, however, is with a company that has already gone public so that the investors can get their shares registered and gain liquidity. It'll usually be on a Form S-3 and would be considered a secondary sale of shares rather than a primary since the proceeds from the sale go to the investors, not to the company. Typically in an IPO the investors are allowed to have a percentage of the overall offering be their shares, but it usually isn't enough to get them the full liquidity they are seeking.

Question: What are the main considerations when determining voting thresholds whether in protective provisions, voting agreements, etc.? Is this something the company can be actively involved in or is it driven more by the investor group?

The company should always be keenly aware of what vote is required for what actions and what group or groups of investors are needed to approve each action. The company should also be wary of any investor gaining control powers that are not commensurate with their overall ownership of the company (i.e. only own 2% of the fully-diluted but has a blocking right on all actions). While the voting thresholds are more a negotiation between the investor syndicate, the party most affected is the company, and the company has just as much say in how governance is going to work.

Question: I've heard that some companies do convertible promissory notes instead of a formal equity financing. Why would a company do this instead and what is the benefit to investors?

Convertible Promissory Note financings are also sometimes called Bridge Financings. Instead of creating and issuing a new series of equity, the company instead issues convertible promissory notes that have a mechanism that allows them to convert into whatever the next round of equity is at a predetermined price or discount. This allows the company to raise cash without having to (1) set a valuation or (2) determine all of the various rights and preferences of the new series of preferred, which is time consuming and can have a big impact on future financings. Bridge Financings are most common with Seed Rounds or with rounds with existing preferred holders (called "Insider Rounds") where they do not want the responsibility of valuing the company. Instead, the money allows the company to continue until it can raise financing from third parties who can give it a fair valuation.