[In response to the publication by the National Venture Capital Association of sample forms for use in venture capital financings, members of the Subcommittee on Transactional Issues and Documents of the Committee on Venture Capital and Private Equity of the Business Section of the American Bar Association met during 2006 and 2007 to discuss their views of these forms. The following has been marked to reflect the comments of these members to the form of Term Sheet prepared by the NVCA. Comments are shown as inserted or deleted text, both within the body of the form and in the footnotes. The Subcommittee welcomes further input on its comments.

As with the NVCA forms themselves, these comments represent only the personal views of a number of attorneys who practice in this area, but do not necessarily indicate the views of their firms nor of the ABA itself. The comments should also not be taken as legal advice for any particular facts or circumstances.]

This sample document is the work product of a coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. See the NVCA website for a list of the Working Group members. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample presents an array of (often mutually exclusive) options with respect to particular deal provisions.

TERM SHEET

[Subcommittee on Transactional Issues and Documents
Committee on Venture Capital and Private Equity
Business Section
American Bar Association
August 2007]

Preliminary Notes

This Term Sheet maps to the NVCA model documents, and for convenience, the provisions are grouped according to the particular model document in which they may be found. Although this Term Sheet is perhaps somewhat longer than a "typical" VC Term Sheet, the aim is to provide a level of detail that makes the Term Sheet useful as both a road map for the document drafters and as a reference source for the business people to quickly find deal terms without the necessity of having to consult the legal documents (assuming of course there have been no changes to the material deal terms prior to execution of the final documents).

TERM SHEET
FOR SERIES A PREFERRED STOCK FINANCING OF
[*INSERT COMPANY NAME*], INC.
[____ __, 200_]

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [___________], Inc., a [Delaware] corporation (the "**Company**"). [In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality [and Counsel and Expenses] provision(s) of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated.] No [other] legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors. This Term Sheet shall be governed in all respects by the laws of the [State of Delaware].

Offering Terms

Closing Date:	As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the "**Closing**"). [*provide for multiple closings if applicable*]
Investors:	Investor No. 1 and its affiliate entities: [_______] shares ([__]%), $[_________] Investor No. 2 and its affiliate entities: [_______] shares ([__]%), $[_________] [as well other investors mutually agreed upon by Investors and the Company]
Amount Raised:	$[________], [including $[________] from the conversion of principal [and interest] on bridge notes].[1]

[1] The investment can be structured as a staged pay-in, with subsequent installments to be invested if the Company has met certain milestones. This type of provision is less common than a single, up-front and unconditional investment. Note that it may invite later disputes concerning milestone achievements and may also increase transaction costs. Some issues that arise are: (1) are the milestones objectively verifiable; (2) if the milestones are met, does that require the investment be made or just give the right to the Company to call in the investment; and (3) what if the milestones have been met, but other events adverse to the Company have occurred (material adverse changes). To clarify what happens when milestones are not met the following language may be added:

> "If, in the sole and absolute judgment of the Investors, the Company has not satisfied a performance milestone by _________, 20__, then the Investors may either (i) waive the failure, in whole or in part, and pay the amount[, or a portion thereof,] set opposite such milestone on Exhibit A[, such payment to be conditioned upon the receipt by the Investors of a written commitment by the Company to use its best efforts to complete the applicable milestone by a specified date and to satisfy such other conditions as the Investors may require,] [(ii) elect not to make such milestone payment but reserve the right to

Price Per Share:	$[________] per share (based on the capitalization of the Company set forth below) (the "**Original Purchase Price**").
Pre-Money Valuation:	The Original Purchase Price is based upon a fully-diluted pre-money valuation of $[_____] and a fully-diluted post-money valuation of $[______] (including an employee pool representing [__]% of the fully-diluted post-money capitalization).
Capitalization:	The Company's capital structure before and after the Closing is set forth below:

	Pre-Financing		Post-Financing	
Security	# of Shares	%	# of Shares	%
Common – Founders				
Common – Employee Stock Pool				
Issued				
Unissued				
[Common – Warrants]				
Series A Preferred				
Total				

CHARTER[2]

Dividends:	[*Alternative 1*: A non-cumulative dividend[3] on the Series A Preferred Stock at the rate of [__]% per annum will be payable only

make subsequent milestone payments by _________, 20__, or] (iii) terminate the Commitment without any further obligation or liability on the part of the Investors.]"

2 The Charter is a public document, filed with the Secretary of State of the state in which the Company is incorporated, that establishes all of the rights, preferences, privileges and restrictions of the Preferred Stock. Note that if the Preferred Stock does not have rights, preferences and privileges materially superior to the Common Stock, then (after Closing) the Company cannot defensibly grant Common Stock options priced at a discount to the Preferred Stock.

3 With a non-cumulative dividend, if the Company's board of directors fails to declare the dividend during any fiscal year, the right to receive that dividend will be extinguished, but no other class of stock will receive a dividend either. The following fiscal year, the same analysis is done again.

This clause is used when the parties want to give the Series A Preferred Stock a dividend preference, but do not want payment of the dividend to be mandatory. This clause is more favorable to the Company than Alternative 2. The Company does not want to be forced to expend cash on dividends that it would otherwise desire to expend on the Company's other purposes. Similarly, the Company does not want to be required to pay any stock dividends that will dilute the ownership percentages of the founders. While this clause favors the Company to some degree, it does when and if declared by the Board and prior to any dividends to any other class.[4]]

[*Alternative 2:* The Series A Preferred Stock will carry an annual [__]% cumulative dividend[5] [compounded annually], payable upon a liquidation or redemption. For any other dividends or distributions

---

give the Series A Preferred Stock Investor a limited preference by making sure that if there is money available for dividends, it will be paid first to the Series A Preferred Stock Investors.

[4] A dividend may be participating or non-participating as follows: (a) after preferred preferential dividends, new preferred does not participate in further dividends, (b) after preferred preferential dividends, new preferred alone participates in dividends on the common, (c) after preferred preferential dividends, new preferred and other specified series participate in dividends on the common, (d) after preferred preferential dividends, common gets specified dividends then new preferred alone participates pro rata in additional dividends on common, OR (e) after preferred preferential dividends, common gets specified dividends then new preferred and other series participate pro rata in additional dividends on common.

[5] With a cumulative dividend, the dividend is calculated each year and the right to receive the dividend is carried forward until either it is paid or the right to receive the dividend is terminated in some way. Thus, there is no need for the dividend to be declared by the Board in order for the right to receive the dividend to accrue. However, the dividend will not actually be paid unless an event requiring payment occurs, such as a fixed payment date, a conversion to Common Stock, liquidation or a redemption.

Sometimes, a term sheet provides that the cumulative dividend will begin to accrue at some time in the future rather than at the time of investment. This is most often done in early stage financings. The delay will typically be one to three years in length.

Alternative 2 is the approach most favorable to the Investors, of those approaches presented. Investors expect to earn their preferred dividends based on how long the Investors have dollars invested in the Company. Thus, this approach has some characteristics similar to an interest charge including, usually, some level of compounding.

In some cases, accrued and unpaid dividends are payable upon conversion as well as upon liquidation or redemption. Typically, however, dividends are not paid if the Preferred Stock is converted. The underlying theory is that Investors are required to make a choice of either having the advantages of being a Preferred Stockholder, or being treated as a Common Stockholder through conversion, consistent with the rights of the other Common Stockholders.

The term sheet will often provide for the payment of the cumulative preferred dividends in stock as opposed to cash. If Common Stock is used to pay the cumulative preferred dividend, it would normally be valued at fair market value and some formulation of how to calculate fair market value will need to be addressed. While the use of Common Stock is the most common alternative for stock dividends, depending upon the goals of the parties, sometimes the parties will decide to use Preferred Stock calculated at the issuance price instead. The Investor should consider the tax consequences of structuring the dividend as a stock dividend.

The issue of who is entitled to determine whether the cumulative dividend is paid in cash or with stock is also subject to negotiation. Both Investors and Companies prefer to be able to make that choice. In most cases, the Company would choose to pay the dividend with cash if cash is available because the issuance of Common Stock will dilute the founders' position in the Company. However, if insufficient cash is available, the Company may be forced to pay the dividend with stock. Depending upon the prospects of the Company, the Investors may find the payment of cash most desirable (particularly in the context of a redemption), but in more favorable contexts may want to receive a stock dividend under the belief that this will prove to be more valuable in the long run. This is particularly likely to be the case in the context of a merger.

An Investor's entitlement to receive a cumulative dividend can increase to very substantial levels over time. When later rounds of financing are raised, the rights of earlier Investors to receive cumulative dividends are frequently renegotiated.

[6] Of the approaches presented, this version is the most favorable to the Company. This clause would be used where the Series A Preferred Stock does not get any kind of a preferred dividend. This will allow the founders to be paid a dividend on their Common Stock without first having to meet any prerequisites for the payment of preferred dividends to the Investors. The Investors' only right will be to participate with the holders of the Common Stock on any dividends that are declared.

declared by the Board, the Series A Preferred Stock will participate with the Common Stock on an as-converted basis.]

[*Alternative 3:* Dividends will be paid on the Series A Preferred Stock on an as-converted basis when, as, and if paid on the Common Stock.][6]

Liquidation Preference:[7]

In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

[*Alternative 1 (non-participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred Stock. The balance of any proceeds shall be distributed to holders of Common Stock.][8]

[*Alternative 2 (full participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred Stock. Thereafter, the Series A Preferred Stock participates with the Common Stock on an as-converted basis.][9]

---

[7] Liquidation preferences are set up to pre-negotiate returns to shareholders in the event of the liquidation or an acquisition of the Company. However, under California law (which may apply to Delaware companies under the Section 2115 long-arm statute) a class vote is typically required in connection with an acquisition event. Where a transaction is of a size that does not provide enough consideration to satisfy preference payments and still provide a return to the common shareholders, the California common shareholder approval statute provides some leverage to common shareholders to obtain at least some return in connection with a transaction. Accordingly, Investors should recognize that the preference payment provisions do not always guarantee a return but may later merely be the basis for a bargaining position among shareholder constituencies. To overcome this issue some Investors insist on shareholder voting agreements or drag-along provisions to ensure that the pre-negotiated returns are honored.

On May 5, 2005, in *VantagePoint Venture Partners 1996 v Examen, Inc.*, the Delaware Supreme Court held that Section 2115 of the California Corporations Code (requiring non-California corporations with contacts in California to adhere to certain California laws governing corporate internal affairs) is unconstitutional; and that the internal affairs of Delaware corporations be adjudicated exclusively in accordance with Delaware law.

[8] Out of the choices listed, this choice is the most favorable to the Company. If the dividend provision provides for a cumulative dividend, the choice "plus accrued dividends" should be selected. If there is not a cumulative dividend, the choice "plus declared and unpaid dividends" should be selected.

Since the Investors will expect some rate of return, if the investment does not carry cumulative dividends one might see a multiplier next to the original purchase price. Otherwise, the Investors could only realize a return through conversion of the Preferred Stock to common equity in a transaction that is generating a return for common shareholders that exceeds the Investors' liquidation preference. A typical multiplier might be two or three times the original purchase price. If the investment carries cumulative dividends and provides for only one times the original purchase price, this is effectively structuring the investment similar to a loan, but without the security that goes with a loan instrument. Most Investors are going to expect to receive more than one times the original purchase price if they do not participate in the balance of the proceeds being distributed in liquidation.

[9] This alternative is usually the most favorable approach for the Investors. See the note under Alternative 1 for an explanation of the choice between "plus accrued dividends" and "plus declared and unpaid dividends."

The concept of participation is the same as that described under the dividends section. If the Series A Preferred Stock has participation rights in liquidation, once the Series A Preferred liquidation preference has been paid, [*Alternative 3 (cap on Preferred Stock participation rights)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred Stock. Thereafter, Series A Preferred Stock participates with Common Stock on an as-converted basis until the holders of Series A Preferred Stock receive an aggregate of [2-5] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).][10]

A merger or consolidation (other than (i) one in which stockholders of the Company own a majority by voting power of the outstanding

---

any remaining proceeds will be distributed to both Common and Series A Preferred holders on an as-converted basis. Because this is the most favorable structure for the Investor out of the choices presented, it is less often that a multiplier in excess of one or two times the original purchase price is used. Nonetheless, depending upon the relative bargaining power of the parties, a higher multiplier may occasionally be seen.

[10] See the note under Alternative 1 with respect to the choice of the clause "plus accrued dividends" or "plus declared and unpaid dividends." Using the approach in this alternative, the Investors in the Series A Preferred Stock will participate with the Common up to an agreed upon level of return, and from that point on, any remaining liquidation proceeds will be distributed only to the holders of the Common Stock.

This clause is an intermediate approach that offers something to both the Company and the Investor. The multiplier on the Series A Preferred Stock liquidation preference is still subject to negotiation. The agreed upon liquidation cap for the Series A Preferred Stock will vary from deal to deal. Generally, in order to determine the best choice of multipliers, both with respect to the preferred part of the return and with respect to the cap on the Series A Preferred Stock return, the parties to the transaction will construct a chart outlining the return to the Series A Preferred holders and the Common Stockholders using varying assumptions as to the liquidation proceeds. The chart developed will then be compared against what the parties believe are possible and probable liquidation returns. This information is then used to negotiate the appropriate multipliers.

[11] The purpose of this clause is to force the distribution of assets to the Investors in the event of a merger or similar transaction that will otherwise not result in the liquidation of the Company.

The final clause of this section is intended to provide a vehicle for allowing the holders of the Series A Preferred Stock to elect out of the forced distribution in the context of a merger, and accept instead, the stock of the survivor of the merger. This flexibility can prove to be invaluable, particularly where there may be one or two participants in the Series A Preferred Stock financing who might be less willing to cooperate than the others. In the absence of this provision, <u>unanimous consent</u> of all of the Series A Preferred Stockholders would be required in order to waive the distribution requirement. This provision also allows preferred shareholders to maintain their investment if they prefer not to be cashed out.

In the context of a merger transaction, it is frequently the case that some of the merger consideration is not determined at the time of closing the merger. There may be an earn-out provision or an indemnification arrangement, either one of which could result in different merger consideration than is initially provided at closing. This is a difficult position for the Investor, who is required to make a decision to convert the Series A Preferred Stock into Common Stock effective as of closing the merger and receive consideration as a Common Stockholder, versus retaining the Series A Preferred Stock, and accepting a distribution of the liquidation preference. In order to avoid having to make a decision at the time the merger is closed, some Investors negotiate an additional clause under the liquidation preference heading, reading as follows:

> "Notwithstanding the foregoing, for purposes of determining the amount each holder of Series A Preferred Stock is entitled to receive upon a Deemed Liquidation Event, upon closing of a Deemed Liquidation Event, if the Series A Preferred Stock has not been converted into Common Stock, then it will be, upon and after the closing of the Deemed Liquidation Event, treated as either Series A Preferred Stock or as converted into Common Stock so as to result in the largest payment to the holder."

shares of the surviving or acquiring corporation or (ii) any transaction if the primary purpose of the transaction is to obtain financing from new or existing investors) and a sale, lease, transfer or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "**Deemed Liquidation Event**"), thereby triggering payment of the liquidation preferences described above [unless the holders of [___]% of the Series A Preferred Stock elect otherwise].[11]

Voting Rights:	The Series A Preferred Stock shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) [so long as at least [*insert fixed number, or %, or "any"*] shares of the Series A Preferred Stock remain outstanding,] the Series A Preferred Stock as a class shall be entitled to elect [_______] [(_)] members of the Board of Directors (the "**Series A Directors**"), (ii) as provided under "Protective Provisions" below or (iii) as otherwise required by law.[12]
Protective Provisions:	So long as at least [*insert fixed number, or %, or "any"*] shares of Series A Preferred Stock remain outstanding, the Company will not, without the written consent of the holders of at least [__]%[13] of the Series A Preferred Stock, either directly or by amendment, merger[14], consolidation, or otherwise: (i) liquidate, dissolve or wind-up the affairs of the Company[, or effect any Deemed Liquidation Event]; (ii) amend, alter, or repeal any provision of the Certificate of Incorporation [or Bylaws] [in a

[12] For California corporations, companies cannot "opt out" of the statutory requirement of a separate class vote by Common Stockholders to (i) authorize shares of Common Stock or (ii) approve a merger or consolidation. See footnote [now] 7 above. As such, Investors may request language as follows:

> "The Company's Certificate of Incorporation will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock."

[13] As with all percentage vote thresholds, consideration will need to be given to whether any single Investor (or affiliated group of Investors) can either control or block the vote. When dealing with multiple classes of Preferred Stock, it is important to understand the composition of the stockholder base to ensure that each series is getting the rights it bargained for. The Company will want the percentage to be high enough so that a significant portion of the Investor base is behind whatever action is being considered and so that an insignificant group (or even merely the aggregation of small, perhaps lost, stockholders who do not respond) cannot block an action desired by most stockholders Especially in subsequent rounds of financing, the determination of whether all series of Preferred Stock vote together as a class or separately as individual series takes on great importance. Note, however, that certain actions affecting the series will remain protected under the applicable state statute (see footnote 8).

[14] In a series of cases, including *Benchmark Capital Partners IV, L.P. v. Vague (2002)* and *Elliot Associates, L.P. v. Avatex Corp. (1998)*, the Delaware Chancery Court held that protective provisions in a charter that provide holders of securities with a class vote before actions can be taken which change or adversely affect their rights do not apply (and thus no class vote is required) if such changes or effects result from a merger, unless the charter expressly provides for such.

	manner adverse to the holders of Series A Preferred Stock];[15] (iii) create or authorize the creation of any new class or series of shares, having rights, preferences or privileges senior to or on parity with the Series A Preferred Stock, or increase the authorized number of shares of Series A Preferred Stock; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred Stock, [other than (a) stock repurchased from former employees or consultants in connection with the cessation of their employment/services, [at the lower of fair market value or cost;] (b) stock repurchased from third parties pursuant to previously disclosed contract rights, or (c) as a result of the Company's exercise of its right of first refusal pursuant to the [First Refusal and Co-Sale Agreement dated _________, 200_][16]; (v) create or authorize the creation of any debt security or enter into new (or extend existing) bank lines of credit [if the Company's aggregate indebtedness would exceed $[____] [other than equipment leases or bank lines of credit] [other than debt with no equity feature] [unless such debt security has received the prior approval of the Board of Directors, including the approval of at least [________] Series A Director(s)]; (vi) increase or decrease the size of the Board of Directors; (vii) authorize any action that results in the sale, lease or transfer of material assets of the Company to any person other than a wholly-owned subsidiary of the Company; [(viii) terminate the existing, or appoint a new, chief executive officer], or [(x) change the Company's material accounting practices or auditors].[17]
Optional Conversion:	The Series A Preferred Stock initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as

---

[15] Note that as a matter of background, Section 242(b)(2) of the Delaware General Corporation Law provides that if any proposed charter amendment would adversely alter the rights, preferences and powers of one series of Preferred Stock, but not similarly adversely alter the rights, preferences and powers of the entire class of all Preferred Stock, then the holders of that series are entitled to a separate series vote on the amendment. This protective provision is broader because it would not require that the Series A Preferred Stock be treated in a manner different from the other series of Preferred Stock.

[16] For California corporations, one cannot reference to a contractual agreement outside the Articles of Incorporation. Regardless of state law requirements, some lawyers prefer not to have a charter document rely, though incorporation by reference, on a non-public document.

[17] The Company may also request that the preferred holders vote together in favor of a merger or sale so long as the preferred holders have received a designated return on their investment (i.e., any merger or sale pursuant to which the preferred holders would receive less than a threshold amount (e.g., 3 times their preference amount) would require consent of the preferred holders). Occasionally, and depending upon specific circumstances, Investors may request non-standard protective covenants (e.g., no change in the business or entry into a new line of business; no guarantees of any obligation, etc.) These requests are unusual, and if they are acceded to, non-objectively verifiable covenants should be placed in the Investors' Rights Agreement so that disputes can be addressed as breaches of contract actions possibly resolved through arbitration.

described below under "Anti-dilution Provisions."[18]

Anti-dilution Provisions: In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred Stock conversion price, such conversion price shall be adjusted in accordance with the following formula:[19]

[*Alternative 1:* "Typical" broad-based weighted average:[20]

$$CP_2 = CP_1 * (A+B) / (A+C)$$

CP_2 = New Series A Conversion Price
CP_1 = Series A Conversion Price in effect immediately prior to new issue
A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)
B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP_1
C = Number of shares of stock issued in the subject transaction]

[*Alternative 2:* Full-ratchet – the conversion price will be reduced to

---

[18] In contrast to mandatory conversion provisions, optional conversion provisions are virtually never subject to negotiation and are regarded as neither Investor nor Company favorable. Although optional conversion allows the preferred holder to convert its Preferred Stock to Common Stock at any time, the most likely situation in which a holder of Preferred Stock will elect to convert is where the holder determines upon a liquidation event that conversion to Common Stock would result in a higher return to the holder than accepting the liquidation preference and participating amount granted to the holder with respect to the Preferred Stock. Hence, the relationship between the conversion clauses and the Liquidation Preference clause (see above) should be considered.

[19] Anti-dilution protection may be combined with a "pay to play" provision. See below. While anti-dilution provisions generally do not trigger taxable events—Section 305(b)(4) of the Internal Revenue Code provides that a change in the conversion price made pursuant to a reasonable adjustment formula that has the effect of preventing dilution of the holders of such stock will not be considered a deemed distribution of stock—care should be taken to avoid conversion price adjustments that might trigger a taxable event, such as adjustments to conversion ratio as a consequence of the payments of dividends to another series of Preferred Stock.

[20] The broad-based weighted average formula presented here is the most commonly used formula and is less favorable to Investors because it takes into account unexercised options and outstanding convertible notes and warrants. This means that the effect of the issuance of shares in the "down round" is diluted or spread over a "broader base." There is also a narrow-based formula that includes only Common Stock issuable upon conversion of a particular series of shares of Preferred Stock outstanding, and not any shares issuable upon exercise of outstanding options or warrant. Given the smaller number of shares deemed to be outstanding in the narrow-based formula, a given dilutive issuance will cause a greater adjustment in the conversion price than with the broad-based formula, which obviously is more favorable to existing Investors. There also exists an even broader based formula as well as other variations of narrow based formulas in which shares reserved in the option pool are included.

the price at which the new shares are issued.][21]

[*Alternative 3*: *No price-based anti-dilution protection.*]

The following issuances shall not trigger anti-dilution adjustment:

(i) securities issuable upon conversion of any of the Series A Preferred Stock, or as a dividend or distribution on the Series A Preferred Stock; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; outstanding on the Closing; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; (iv) [up to [________]] shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [_______] Series A Director(s)[22]]; [(v) shares of Common Stock issued or issuable to banks, equipment lessors pursuant to a debt financing, equipment leasing or real property leasing transaction [approved by the Board of Directors of the Corporation] [, including at least [_______] Series A Director(s)]; [(vi) securities issued in transactions of primarily a strategic not

---

21 The full ratchet provision is quite draconian to the Company's existing holders of Common Stock and is typically objected to strenuously. It provides that upon a dilutive financing the conversion price of the diluted shares will be adjusted downward to the issuance price of the newly issued shares, regardless of how many of the new shares are actually issued. Its effect is to fix the price of the prior round to the price of the lowest priced follow-on, without regard to the relative size of the rounds. Often such a provision will be limited in duration (e.g. applicable to issuance for a period of X months or applicable through the closing of the Company's next financing of a specified size or until certain milestones are reached) after which the anti-dilution protection changes to a weighted average formula or ceases altogether. Thus, the Investors will receive greater protection during the riskier phase of their investment and the existing holders of Common Stock will receive protection from the effects of full ratchet protection after having successfully navigated the riskier phase. From a Company standpoint, if a ratchet anti-dilution provision is included, it is important to pay extra attention to ensure that the exceptions from its application in the Articles/Certificate are broadly crafted so as not to trigger adjustments in stock issuances that are not related to equity financing activities. A Company might consider including the following provisions to reduce the impact of a full ratchet provision: (i) a "pay to play" provision (see below), (ii) a shareholder cap (i.e., any increases in percentage ownership of the Company are capped at a set level), and (iii) a share price floor (i.e., if the price per share in a down round is below a certain set price, the full ratchet protection is suspended and the holders of Preferred Stock are only entitled to weighted average anti-dilution protection). Full-ratchet anti-dilution is more likely to be used when the Company is in a weakened bargaining position, such as a down round when the Company is stressed and financing is hard to obtain.

Other the other hand, ratchet anti-dilution can sometimes be a useful compromise position for a Company to obtain a higher valuation from an Investor than the Investors thinks warranted. In effect, the Investor is willing to give the Company the benefit of the higher price, so long as a subsequent financing does not occur at lower price.

22 Examiners at the California Secretary of State have taken the position that these types of provisions do not comply with Sections 307(a) and 204(a)(5) of the California Corporations Code. In the view of the Secretary of State, in the circumstances described in this provision, the Board is required to decide whether or not to issue securities that may or may not give rise to anti-dilution adjustments depending on the vote of the Series A representative. This results in the Series A representative having greater authority than the other directors in approving such issuances, which is not permitted under the California Corporations Code.

a financial nature; (vii) securities issued pursuant to an acquisition of another corporation or other entity by the Company; or (viii) securities that are otherwise excluded by vote or written consent of holders of a [__]%[23] of Series A Preferred Stock.][24]

Mandatory Conversion:	Each share of Series A Preferred Stock will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a [firm commitment] underwritten public offering with a price of [___][25] times the Original Purchase Price (subject to adjustments for stock dividends, splits, combinations and similar events) and [net/gross][26] proceeds to the Company of not less than $[_______] (a "**QPO**"), or (ii) upon the written consent of the holders of [__]%[27] of the Series A Preferred Stock.[28]
[Pay-to-Play[29]:	[Unless the holders of [__]% of the Series A elect otherwise,] on any subsequent [down][30] round all [Major][31] Investors are required to participate to the full extent of their participation rights (as described

[23] The percentage in this section usually matches the percentage in the Protective Provisions section.

[24] Less commonly, a Company may be successful in including an exclusion from anti-dilution protection for shares issued at fair market value or shares issued in excess of a fixed dollar amount. This may be more appropriate where the Investors exercise significant control over the Company.

[25] The multiples used in this provision depend generally on the stage of the Company and investment climate at the time of the offering. A higher multiple (e.g., four or five times the Original Purchase Price) would be more Investor favorable, whereas a lower multiple is a more Company favorable approach.

[26] Using gross proceeds is more Company favorable. An even more Company favorable approach would be to use the following language for the total threshold: "and for a total offering of not less than $[___], before deduction of underwriters' commissions and expenses." The thresholds for the per share price and the aggregate offering are often negotiated. Investors will request high thresholds in order to gain greater control over the timing and the terms of an IPO whereas the Company will want to keep such thresholds low to preserve more flexibility. Care should be taken to ensure that the thresholds for a new series of Preferred Stock do not differ from the thresholds negotiated for holders of all other series of Preferred Stock so that a single series cannot hold up a public offering.

[27] More Investor-friendly provisions often use a two-thirds threshold, whereas a more Company-friendly provision would use a majority threshold. Also from the Company's perspective, if more than one series of Preferred Stock will be issued, care should be taken to ensure that the holders of Preferred Stock will vote together as a single class upon the issue of automatic conversion. Otherwise, a single series of preferred could block the transaction. On the other hand, holders of a series that has a higher original purchase price may want to have the series vote independently of lower priced series, since their respective returns on investment will be different.

[28] The per share test ensures that the Investor achieves a significant return on investment before the Company can go public. Also, consider allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the Investor, so that the Investor does not have the power to block a public offering.

[29] See the pay-to-play Section of the Model Amended and Restated Certificate of Incorporation for additional comments before negotiating this section of the Term Sheet. Also please note that although this Term Sheet (as do most) includes the pay-to-play provisions under the section entitled "Charter," some practitioners prefer to effect the pay-to-play consequences through a contractual waiver or arrangement which is included in one of the other financing documents (e.g., Stock Purchase Agreement). Such an arrangement still requires some language in the Charter to make it clear that such a contractual provision is effective (and is effective against future holders of the stock), but that specificity would not likely be addressed in the Term Sheet for a contractual form of pay-to-play

provision. The contractual (vs. Charter) approach is important in the event not all holders of the same series will be treated in an identical manner (e.g., strategic corporate Investors) (see footnote 20). For an example of a contractual waiver model of a pay-to-play provision, please *see* Venture Capital & Public Offering Negotiation (3rd ed.), Holloran et al, Aspen Law & Business (pp. 8-47 through 8-50). See also drafting considerations discussed in footnotes 10-14, *infra*.

There are many points in the Term Sheet where Company counsel can (and in some cases, should) solicit the assistance or counsel of other Investors in the Company before the Term Sheet is signed. The pay-to-play provision is of particular importance to non-lead Investors. Even if the Company itself may be in favor of a pay-to-play provision (e.g., future funding incentive, possible preferred overhang reduction, etc.), if the Company has had prior Investors (i.e., angel rounds, convertible debt rounds, etc.) or if the Company and/or its officers have been the main point of contact with some of the non-lead Investors in the financing under negotiation, Company counsel should make sure to point out to these non-lead Investors the likely consequences of this particular term and allow them the opportunity to have input on either negotiating the pay-to-play out of the Term Sheet or negotiating limitations and exceptions.

Note that the legality of a pay-to-play provision is arguably more certain following the recent *Watchmark* case in Delaware. *Watchmark Corp. v. Argo Global Capital, LLC et al*, 2004 Del. Ch. LEXIS 168; *app. denied* by *Watchmark Corp. v. ARGO Global Capital, LLC et al*, 2004 Del. LEXIS 175 (Del., Nov. 15, 2004); *app. denied by ARGO Global Capital, LLC et al v. Watchmark Corp. et al,* 2004 Del. LEXIS 551 (Del., Nov. 23, 2004). This case held that, at least in certain circumstances, a pay-to-play provision will be enforceable. Since pay-to-play provisions are often adopted in connection with a down round financing (including being put in place on the eve of such a financing), similar considerations apply to the adoption of pay-to-play provisions as apply to other terms of such a financing (e.g., whether the Board complied with fiduciary duties owed to its current shareholders in accepting terms which may cause certain shareholders to lose rights as a result of the pay-to-play). This is particularly true where the Company is negotiating with a subset of its current Investors who are providing the new capital, and the pay-to-play affects other Investors who are not in a position to participate or negotiate the terms. Company counsel should advise the Board to specifically consider the pay-to-play provisions when making its decision on whether the terms of the financing are in the best interest of the Company and its stockholders.

In some circumstances, particularly in Series B or later rounds where a subset of prior Investors is leading the new round, the participating Investors expect that the pay-to-play provision being adopted in connection with the financing under negotiation *will apply to non-participants in that same financing*. In other words, the pay-to-play isn't being adopted merely to provide incentive to participate in financings that may occur at some time in the future, but it is to be applied immediately as a punishment (or, in the eyes of participating Investors, an appropriate incentive to participate and adjustment for not) to those not participating in the current financing. This is sometimes referred to this as an 'eve of financing' pay-to-play, and the Company's board of directors should be particularly mindful of its fiduciary duties (and possible self-interest in the case of certain directors) in such cases.

In some Series B or later rounds, participating Investors want to provide strong incentive for prior Investors to participate in the current round but do not have the voting power that would be necessary to alter the terms of the currently outstanding series of Preferred Stock (i.e., in order to put an eve-of-financing pay-to-play in place with respect to already outstanding shares). In these cases, Investors will often achieve a similar result to an eve-of-financing pay-to-play by structuring the financing as a "pull-through" financing. In a pull-through financing, those holders of the existing Preferred Stock (let's say there are Series A Preferred Stock outstanding and the Company is negotiating a Series B financing) who elect to participate in the Series B financing are allowed to "pull through" or exchange or convert shares of their Series A stock for shares of either the new Series B or, more often, shares of a new series of Preferred Stock (i.e., Series A-1 or Series B-1) which is similar to the Series A, but senior in liquidation and convertible at a much better rate. The purchase price of the Series B financing (and the conversion rate of the new Series A-1) is set in such a manner as to reflect what the new Investors perceive to be a correct valuation of the Company, taking into account any anti-dilution adjustments that the non-participating Series A stockholders will experience upon issuance of the Series B and the new Series A-1, which may be significant. This usually results in a dramatic change in the number of shares outstanding and can be demoralizing for management, unless the financing is accompanied by a new set of option grants based on the new fully-diluted capitalization. The new option grants would not remedy the situation of those Common Stockholders who are not current employees, so the potentially drastic dilution such non-employee Common Stockholders will face should be considered by the board of directors when considering whether to accept the terms of such a financing.

[30] Note that the rationale for having a pay-to-play is stronger in "down rounds" (or "Dilutive Issuances" in more common Charter parlance), reasoning that those who aren't willing to back the Company when its outlook becomes bleaker should not get the benefit of any price protection adjustments arising in the down round financing, and

should lose at least some privileges thereafter. However, many larger Investors may require that a pay-to-play provision apply in *any* future financings, including up rounds. This seems to rely less on policy and more on self-interest of the larger Investors to ensure that their syndicates contain only sufficiently capitalized members committed to providing the funding required to achieve a successful exit.

[31] For the pay-to-play to apply to only Major Investors, pay-to-play provisions need to be contractual outside of the Certificate of Incorporation; within the Certificate of Incorporation, all shareholders holding the same class of shares need to be treated in the same manner. Having the pay-to-play apply only to "Major" Investors (or any subset of Investors for that matter) is relatively uncommon at this time. However, when negotiating the term sheet, Company counsel should take into account whether there are existing groups of Investors who will have Preferred Stock (i.e., if this is a Series B round, or if earlier Investors with convertible notes will convert into Series A as part of the financing under negotiation) who will object to pay-to-play provisions. There may be good policy reasons for giving an "out" of the pay-to-play provisions to angel groups and certain early stage Investors who fill a crucial funding gap in seeding start-up companies (e.g., these types of Investors have fulfilled their 'mission' in providing the early stage capital, and they often don't have the capital or the contractual ability to invest in increasingly large future rounds). This being said, larger venture funds are often unwilling to allow for any such exceptions. Additional exceptions commonly discussed include exceptions for corporate venture funds (i.e., Intel Capital) or an institution that is receiving or purchasing Preferred Stock as part of a spin-out of the Company's core technology.

[32] Company counsel (in its role as advisor to the Board) should keep in mind the conflict of interest this particular provision may cause in the common situation where the Series A Directors are designated/elected by the largest Series A Stockholders which will also be the Investors who are most likely to participate in a future financing (and thus avoid the negative consequences of the pay-to-play provision). Including the requirement that the Series A Directors consent to waiving the pay-to-play may mean, in effect, that the pay-to-play provision may never be waived, since these designated Series A Directors may feel the need to abstain from any such vote, consent or waiver on such a topic, potentially leaving the Company unable to meet this requirement.

[33] Company counsel or the non-lead Investors may consider negotiating some additional exceptions or limitations to the pay-to-play provisions. There are many types of exceptions and limitations that may be negotiated, including:

- A provision that after any Series A Stockholder (together with its affiliates) has invested a certain amount in future financings, the pay-to-play provision will no longer apply to such Series A stockholder (and its affiliates). This could be expressed as a certain dollar amount, but may make more sense expressed as a multiple of the original Series A investment made by such Investor (i.e., after any Investor and its affiliates have made additional investments of 1x, 1.5x, 2x, etc. times their original Series A investments, then the pay-to-play no longer applies).
- A provision that there may be only one dilutive financing triggering the pay-to-play financing in any twelve-month period.
- A provision that if a dilutive financing is in excess of a certain amount (i.e., $10,000,000), then each [Major] Investor is only required to invest its Pro Rata portion of such threshold amount in order to avoid being punished by the pay-to-play provisions.
- Carve-outs for angel Investors, angel funds, seed stage Investors, institutions or corporate Investors.
- Provisions that the pay-to-play only applies to certain series of Preferred Stock.

In negotiating carve-outs, as with all portions of the pay-to-play, keep in mind the general rule that each share of stock of the same series must have the same rights, preferences and privileges as other shares of the same series – so that the more specific a carve-out becomes, the more thought needs to go into how to appropriately draft such carve-outs. Disparate treatment among holders of the same series should be address through contractual provisions outside the Charter. See discussion in footnote 18, *supra*.

[34] Alternatively, this provision could apply on a proportionate basis (e.g., if Investor plays for ½ of pro rata share, receives ½ of anti-dilution adjustment). Note that the pay-to-play provision upheld in *Watchmark* provided for such proportionate application.

[35] If the punishment for failure to participate is losing some but not all rights of the Preferred Stock (e.g., anything other than a forced conversion to common), the Charter will need to have so-called "blank check preferred" provisions at least to the extent necessary to enable the Board to issue a "shadow" class of preferred with diminished

below under "Investor Rights Agreement – Right to Participate Pro Rata in Future Rounds"), unless the participation requirement is waived for all [Major] Investors by the Board [(including vote of [a majority of] the Series A Director[s][32])][33]. All shares of Series A Preferred Stock[34] of any [Major] Investor failing to do so will automatically [lose anti-dilution rights] [lose right to participate in future rounds] [convert to Common Stock and lose the right to a Board seat if applicable].[35]

Redemption Rights:[36]	The Series A Preferred Stock shall be redeemable from funds legally available for distribution at the option of holders of at least [__]% of the Series A Preferred Stock commencing any time after the fifth anniversary of the Closing at a price equal to the Original Purchase Price [plus all accrued but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred Stock, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)].[37]

STOCK PURCHASE AGREEMENT

Representations and Warranties:	Standard representations and warranties by the Company.[38]
Conditions to Closing:	Standard conditions to Closing, which shall include, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing

rights in the event an Investor fails to participate. Note that as a drafting matter it is much easier to simply have (some or all of) the preferred convert to common.

The so-called "strongman pay-to-play" (in which the consequences are having all Preferred Stock converted to Common Stock) provides much stronger incentive to the Investors to participate in subsequent rounds, and also has the added benefit (from certain perspectives) of reducing the Company's "preference overhang" which has the side effect of benefiting management and other holders of Common Stock or options.

36 Redemption rights allow Investors to force the Company to redeem their shares at cost plus a small guaranteed rate of return (e.g., dividends). In practice, redemption rights are not often exercised; however, they do provide a form of exit and some possible leverage over the Company. While it is possible that the right to receive dividends on redemption could give rise to a Code Section 305 "deemed dividend" problem, many tax practitioners take the view that if the liquidation preference provisions in the Charter are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the NVCA model Certificate of Incorporation), then there is no Section 305 issue.

37 Due to statutory restrictions, it is unlikely that the Company will be legally permitted to redeem in the very circumstances where Investors most want it (the so-called "sideways situation"), Investors will sometimes request that certain penalty provisions take effect where redemption has been requested but the Company's available cash flow does not permit such redemption - - e.g., the redemption amount shall be paid in the form of a one-year note to each unredeemed holder of Series A Preferred, and the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company's Board of Directors until such amounts are paid in full.

38 Note that while it may not be uncommon in East Coast deals to require the Founders to personally represent and warrant (at least as to certain key matters, and usually only in the Series A round), such Founders representations are almost never seen in West Coast deals.

of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, and an opinion of counsel to the Company.

Counsel and Expenses:	[Company] counsel to draft financing documents. Contingent upon closing the financing, the Company shall pay the investors' legal expenses up to a limit of $[_____] with respect to the transaction, [payable at Closing], which amount will be reviewed and, if appropriate, increased upon commencement of the negotiation of the definitive transaction documents. Company Counsel: [____________________ ____________________ ____________________] Investor Counsel: [_________________________ _________________________ _________________________]

INVESTOR RIGHTS AGREEMENT

Registration Rights:

Registrable Securities:	All shares of Common Stock issuable upon conversion of the Series A Preferred [and any other Common Stock held by the Investors] [and Common Stock held by Founders] will be deemed "**Registrable Securities**."[39]
Demand Registration:	Upon earliest of (i) [4-6] years after the Closing; or (ii) [six] months following an initial public offering ("**IPO**"), persons holding [__]%[40] of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than $[5-10] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).

[39] Note that Founders/management sometimes also seek registration rights.

[40] The Company will want the percentage to be high enough so that a significant portion of the Investor base is behind the demand (*e.g.*, to cause the Company to effect a registered offering, particularly an IPO). Companies will typically resist allowing a single minority Investor to cause a registration. Experienced Investors will want to ensure that less experienced Investors do not have the right to cause a demand registration. In some cases, different series of Preferred Stock may request the right for that series to initiate a certain number of demand registrations. Companies will typically resist this due to the cost and diversion of management resources when multiple constituencies have this right.

Registration on Form S-3: The holders of [10-30]% of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate offering price of at least $[1-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [1] per year.

Piggyback Registration: The holders of Registrable Securities will be entitled to "piggyback" registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [30]% on a pro rata basis and to complete reduction on an IPO at the underwriter's discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders' shares are reduced.

Expenses: The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions will be borne by the Company. The Company will also pay the reasonable fees and expenses [, not to exceed $______,] of one special counsel to represent all the participating stockholders.[41]

Lock-up: Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company [(excluding shares acquired in or following the IPO)] for a period of up to 180 days (plus up to an additional 18 days to the extent necessary to comply with applicable regulatory requirements) following the IPO (provided all directors and officers of the Company and [1 – 5]% stockholders agree to the same lock-up). Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to [Major] Investors, pro rata, based on the number of shares held. A "**Major Investor**" means any Investor who purchases at least

---

[41] Registration of the sale of shares of a Company is an expensive undertaking — and the most expensive registration of all is a Company's initial public offering. Generally, registration expenses include SEC filing fees, attorney's fees, accounting fees, printing expenses, and the travel costs of a "road show." Initial public offering expenses can easily end up in seven figures.

It is customary for the Company to provide a certain number of demand registrations at its expense (as provided above). When the Company and the Investors cannot agree on the number of such registrations, one compromise is to allow the Investors to have a certain number of additional registrations at the Investors' expense. However, if this compromise is adopted, the Investors should insist that certain costs not be borne by them. The Investors should not have to pay (i) the costs of the Company's normal audit or (ii) any soft costs of Company personnel time. Moreover, if other selling stockholders are included in the registration statement, they should pay their pro rata share of the expenses. See J. Freund, Anatomy of a Merger, (1975), 351.

$[______] of Series A Preferred.[42]

Termination:	Earlier of [3-5] years after IPO, upon a Deemed Liquidation Event, or when all shares of an Investor are eligible to be sold without restriction under Rule 144(k) within any 90-day period.[43]
	[Except for pari passu registration rights granted in connection with debt financing], no future registration rights may be granted without consent of the holders of a [majority] of the Registrable Securities unless subordinate to the Investor's rights.[44]
Management and Information Rights:	[A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.][45]
	Any Major Investor [(who is not a competitor)] will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such Major Investor (i) annual, quarterly, [and monthly] financial statements; (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for

---

42 During the offering and aftermarket periods, the underwriters do not want other stockholders to sell shares in competition with the underwriters, both because more available shares will sop up demand for the registrant's shares and because the increased supply will depress the aftermarket price of the shares. Accordingly, the underwriters will require other holders of shares, whose shares are not included in the public offering but who may be able to sell pursuant to SEC Rule 144, to agree not to sell during the offering period and an appropriate aftermarket period. A 180-day period for an IPO is customary.

Shareholders are generally reluctant to agree to do this because it eliminates their liquidity during the lock-up period; this reluctance is tempered, however, by their desire for a successful initial public offering with aftermarket prices exceeding the public offering price.

This provision commits the Investors to agree to the underwriters' demands only if other stockholders do so as well. The underwriters generally want shares owned by officers, directors and "large" stockholders to be subject to the lock-up arrangements, but are not concerned if small amounts of shares are free to sell. However, the definition of a "large" stockholding is subject to some negotiation. The underwriters do not want sales of shares in the open market after the deal over which they have no control to affect the market price of the stock in (or "overhang") the market. Venture Investors may simply not want anyone else to be able to sell if they cannot.

43 Given the expense and general hassle of the securities registration process, the Company wants the commitment to engage in the process to lapse as soon as possible, while the Investors want the maximum liquidity period possible. The principle of this provision is that no stockholder is entitled to require the Company to register the sale of shares if the registration is unnecessary since the stockholder can just as easily sell under Rule 144(k) (and for a lower commission).

44 Since the size of a public offering is determined by market conditions, it is possible that selling shareholders may seek to sell more shares than the offering can accommodate. In this case, the underwriters will "cut back" the shares to be sold by the selling stockholders. See "Piggyback Registration" previously discussed. The problem for the Investors is simply that the more shares eligible to be registered, the greater the cutback would be. To solve this problem, the Investors do not want the eligibility pool to be increased without their consent.

45 See commentary in introduction to NVCA model Managements Rights Letter, explaining purpose of such letter.

the upcoming fiscal year; and (iii) promptly following the end of each quarter an up-to-date capitalization table [, certified by the CFO.][46]

Right to Participate Pro Rata in Future Rounds:

Each [Major] Investor shall have the right to purchase its Pro Rata Share (as defined below) of all subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet and issuances in connection with acquisitions by the Company). "**Pro Rata Share**" means, with respect to any [Major] Investor, the percentage determined by dividing the number of shares of capital stock held by such [Major] Investor by [the total shares of all class outstanding assuming conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans and outstanding warrants] [the total number of shares of capital stock held by all [Major Investors]][47]. In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

Non-Competition and Non-Solicitation Agreements:[48]

Each Founder and key employee will enter into a [one] year [non-competition] and non-solicitation agreement in a form reasonably acceptable to the Investors.

Non-Disclosure and Developments Agreement:

Each current and former Founder, employee and consultant with access to Company confidential information/trade secrets will enter into a non-disclosure and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.

---

[46] It should come as no surprise that venture Investors want the information and access necessary to monitor their investment. Conversely, the Company wants to spend as much time as possible running the business and as little as possible fielding Investor inquiries. Consequently, if the Investors have board representation, the Company may ask that the information and access provided to the designated director(s) should constitute delivery to the Investor. A compromise in this situation is to provide information to non-director Investors upon request.

[47] Investors sometimes limit the denominator in the Pro Rata Share calculation to increase the percentage of subsequent financings they are entitled to purchase.

[48] Note that non-compete restrictions (other than in connection with the sale of a business) are prohibited in California, and may not be enforceable in other jurisdictions, as well. In addition, some Investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a Non-Compete/Non-Solicit (and indeed the agreement may arguably be invalid absent such additional consideration - - although having an employee sign a non-compete contemporaneous with hiring constitutes adequate consideration). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Non-competes typically have a one-year duration, although state law may permit up to two years. Many states have a reasonableness requirement, which may have been interpreted under case law to allow as much as up to two or three years, depending on the industry. Courts will look at how quickly the competitively sensitive information goes stale in that industry, as well as how broad the non-compete's application is geographically and by industry. If the Founder is in a strong bargaining position and in an industry in which information goes stale quickly, the Founder may feel that the non-compete term should be as little as six months.

Board Matters:[49]

[The Board of Directors shall meet at least [monthly] [quarterly], unless otherwise agreed by a vote of the majority of Directors.]

The Company, to the extent allowed under its [charter], [certificate of incorporation], [by-laws], [other insurance contracts] and [general contracts] will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors; provided, however, that if such D&O insurance is not available to the Company or such D&O insurance would be unreasonably expensive for the Company in relation to the benefits to the Company, then the Company shall not be required to obtain and maintain such insurance. In the event the Company merges with another entity and is not the surviving corporation, or transfers all of its assets, proper provisions shall be

---

[49] Investors sometimes require that Board approval of certain corporate actions must include one or more of the Investor directors. If Investor directors control the board following Series A financing, these covenants would be superfluous, though that does not seem to cause them not to be requested. In addition, Investor director veto rights can set a precedent for future rounds, which can result in cumbersome board votes that require specific approval of several Investor directors. In practice, Investor directors should bear in mind that they owe a fiduciary duty to the corporation and all stockholders in voting as a director regarding these matters. Special Investor director voting rights should not be used to push an Investor's agenda to the detriment of the other stockholders.

See a sample provision:

> "**Matters Requiring Investor Director Approval**: [So long as [__]% of the originally issued Series A Preferred remains outstanding,] the Company will not, without Board approval, which approval must include the affirmative vote of [____] of the Series A Director(s): (i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company; (ii) make any loan or advance to any person, including, any employee or director, except advances and similar expenditures in the ordinary course of business or under the terms of a employee stock or option plan approved by the Board of Directors; (iii) guarantee, any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business; (iv) make any investment other than investments in prime commercial paper, money market funds, certificates of deposit in any United States bank having a net worth in excess of $100,000,000 or obligations issued or guaranteed by the United States of America, in each case having a maturity not in excess of [two years]; (v) incur any aggregate indebtedness in excess of $[_____] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business; (vi) enter into or be a party to any transaction with any director, officer or employee of the Company or any "associate" (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such person [except transactions resulting in payments to or by the Company in an amount less than $[60,000] per year], [or transactions made in the ordinary course of business and pursuant to reasonable requirements of the Company's business and upon fair and reasonable terms that are approved by a majority of the Board of Directors]; (vii) hire, fire, or change the compensation of the executive officers, including approving any option plans; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; or (ix) sell, transfer, license, pledge or encumber technology or intellectual property, other than licenses granted in the ordinary course of business."

	made so that successors of the Company assume Company's obligations with respect to indemnification of Directors.
Employee Stock Options:	Unless otherwise approved by the Board [or a committee established by the Board], [which approval must include the affirmative vote of [____] of the Series A Director(s),] all employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months]. [Immediately prior to the Series A Preferred Stock investment, [______] shares will be added to the option pool creating an unallocated option pool of [_______] shares.]
Key Person Insurance:	Company to acquire life insurance on Founders [*name each Founder*] in an amount satisfactory to the Board. Proceeds payable to the Company.
[IPO Directed Shares:[50]	To the extent permitted by applicable law and SEC policy, upon an IPO consummated one year after Closing, Company to use commercially reasonable efforts to cause underwriters to designate [1-5]% of the offering as directed shares, 50% of which shall be allocated by Major Investors.]
[QSB Stock:	Company shall use commercially reasonable efforts to cause its capital stock to constitute Qualified Small Business Stock unless the Board determines that such qualification is inconsistent with the best interests of the Company.]
Termination:	All rights under the Investor Rights Agreement, other than registration rights, shall terminate upon the earlier of an IPO or a Deemed Liquidation Event.

RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT AND VOTING AGREEMENT

Right of first Refusal/	Company first[51] and Investors second [(to the extent assigned by the

[50] SEC Staff examiners have taken position that, if contractual right to friends and family shares was granted less than 12 months prior to filing of registration statement, this will be considered an "offer" made prematurely before filing of IPO prospectus. So, Investors need to agree to drop shares from offering if that would hold up the IPO. While some documents provide for alternative parallel private placement where the IPO does occur within 12 months, such a parallel private placement could raise integration issues and negatively affect the IPO. Hence, such an alternative is not provided for here.

[51] Investors may take the position that they should be granted the primary right of first refusal with respect to transfers by the Founders based on the arguments that (a) a redemption of Founder stock by the Company may constitute a preferred distribution that would deplete the Company of cash that ought to be reinvested into operations or otherwise used to pay accumulated dividends on the Series A Preferred Stock, and (b) the Investors want the first opportunity to increase their percentage ownership, rather than having a Company redemption increase all shareholders' percentage ownership pro rata. Note the interplay between this provision and the Investors' protective provision with

Right of Co-Sale (Take-me-Along):

Board of Directors,)] will have a right of first refusal with respect to shares of capital stock of the Company proposed to be transferred by Founders [and employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock)],[52] [with a right of oversubscription for Investors of shares unsubscribed by the other Investors].[53] Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.[54] These rights of first refusal and co-sale shall be subject to certain standard exceptions.[55]

Board of Directors/Voting Agreement [56]:

Immediately after the Closing, the Board will consist of [______] members. The holders of Series A Preferred Stock will have the right to designate [____] director(s) with [_____] having the right to designate [____] director(s) [57], who initially will be [_________].

---

respect to Company purchases or redemptions of stock. Investors may be less concerned with the Company being granted the primary right of first refusal if such protective provision does not contain an exception for the Company's exercise of such right.

52 In larger financings involving multiple Investors with one or more lead Investors or significant participation from strategic Investors, the lead Investors or strategic Investors may seek rights of first refusal and co-sale from other Investors participating in the financing. Among other reasons, lead Investors may wish to have some control over changes in the composition of the Investor group, and strategic Investors will view it as a mechanism to prevent other, competing strategic participants from becoming affiliated with the Company. When confronted with such a request, the Company should consider how such provisions will affect its ability to fill out the round, and the added complexity that will result.

53 The Founders may insist on language making clear that the right of first refusal only applies to the extent that the Company and the Investors collectively will purchase all (rather than any portion) of the shares sought to be transferred by the Founder. The ability of the Company and the Investors to purchase less than all of the shares sought to be transferred may have a significant chilling effect on a Founder's ability to sell the balance of the shares at a favorable price.

54 The exercise of a right of co-sale raises certain issues regarding the terms on which Investors may participate in the sale by the Founder or other stockholder, some of which the Company, Founders and Investors may wish to negotiate at the term sheet stage. See footnote under the drag along provision for further discussion on this point.

55 Certain exceptions are typically negotiated, e.g., estate planning, *de minimis* transfers, any sale to the public pursuant to an effective registration statement or any bona fide gift to a charitable organization. The Company or Founders may wish to include these exceptions in the term sheet rather than defer negotiation to the definitive documents.

56 Investor counsel sometimes will seek to have the Investors' Board of Director rights imbedded in the Company's charter with the view that such approach creates a right that the Investors may exercise without cooperation from any other stockholder and which may be more enforceable in the event of a dispute. The Company often will object to this on the basis that it creates undue complexity and can result in significant complications and formality with respect to the management of such rights.

57 The mechanics for determining how the directors to be designated by the holders of the Series A Preferred Stock vary depending upon the composition of the Investor group. Lead Investors often will require that they have the right to choose at least one of such directors. Alternatively, where the Investor group is evenly balanced, such directors may be chosen by a majority of the holders of Series A Preferred Stock. Similar issues may arise with respect to the designation of the Common Stock directors. Investors who are unable to control the designation of the preferred directors may negotiate for the right to appoint an observer to attend meetings of the Board of Directors. Additionally, the Company may seek to limit the number of preferred directors by instead offering the Investors the right to designate

The holders of the Common Stock will be entitled to designate [_____] director(s), one of whom will be the Chief Executive Officer of the Company, and who initially will be [______________]. The Series A Preferred Stock and Common Stock, voting as one class, will be entitled to designate [_________] director(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].[58]

The directors shall be entitled to reimbursement of reasonable costs of attendance at meetings of the Board.[59]

[*Drag Along:*

Holders of Preferred Stock and the Founders [and all current and future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares[60] in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred [for a price that is greater that [2] times the aggregate liquidation preference of the Preferred Stock provided that the purchase price is paid in accordance with the terms of the liquidation preference set forth herein], approved by [the Board of Directors]

---

one or more observers. Accordingly, this provision may be drafted in a number of different ways to reflect the various mechanics and rights.

58 The Company, Founders and Investors sometimes may require more stringent independence requirements for such directors in addition to being non-employees. For example, in instances in which the balance of Investor and Founder representation on the Board of Directors is heavily negotiated, the parties may be able to reach a compromise by agreeing on a certain number of additional directors who satisfy more stringent independence requirements.

59 The Company may wish to negotiate for certain limitations to the obligation to reimburse directors for costs of attendance at meetings, including clarifying that only travel related expenses will be reimbursed and that such reimbursement must be in accordance with the Company's travel policies applicable to executive officers. While such an approach may be reasonable, the dynamics of the negotiations and relationship between the Company and the Investor group may be such that the Company does not want to raise this issue at the term sheet stage. Some Investors may resist for purely administrative reasons or on the basis of not wanting to be second-guessed on such matters.

60 In addition to requiring stockholders to vote their shares in favor of a transaction, Investors may want to require that the drag-along agreement require stockholders to sell their shares in a similar transaction if it is structured as a stock sale rather than a merger or asset sale. Regardless of whether or not such a requirement is included and what the structure of a drag-along transaction is, the mechanics of a drag-along raise issues regarding the non-economic terms on which stockholders may be dragged along. For example, stockholders who are being dragged-along understandably may not be willing to execute the operative transaction agreement to make representations and warranties (whether personal or with respect to the Company), be obligated to any extent with respect to indemnification in favor of the buyer or make post-closing covenants such as covenants not to compete. However, the buyers often will insist on at least some of the stockholders being parties to such provisions, and the drag-along right may have little value absent the Investors' ability to require stockholders to do more than just vote in favor of the proposed transaction. Common compromises included in term sheets are that only Founders will be required to execute the transaction documents, limitations the representatives and warranties required to be made by Founders or that no stockholder will be required to agree to any potential indemnification liability in excess of a percentage of their proceeds from the transaction. There are no easy answers to these issues, but the parties should be cognizant of them and may want to confront them at a basic level in the term sheet.

	[and the holders of a [majority][super majority] of the outstanding shares of Preferred Stock, on an as-converted basis][61].
[Company Right of First Refusal on Investor Sales:	The Company shall have a right of first refusal to acquire all securities proposed to be transferred or sold by an Investor, subject to customary exclusions.][62]
Termination:	All rights under the Right of First Refusal/Co-Sale and Voting Agreements shall terminate upon (a) an IPO, (b) a Deemed Liquidation Event, or (c) at such time as no Series A Preferred Stock remains outstanding.

OTHER MATTERS[63]

Founders' Stock:	All Founders to own stock outright subject to Company right to buyback at cost. Buyback right for [__]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [__] months.
[*Existing Preferred Stock[64]:*	The terms set forth below for the Series [_] Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing Preferred Stock to this term sheet will be made at the Closing.]
[No Shop/Confidentiality:	The Company agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, for a period of [2-4] weeks from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of

61 Additional or alternative conditions to the Investors' exercise of the drag-along right may be negotiated, including the requirement of a fairness opinion from an independent investment bank, approval by independent directors or Founder directors, consideration being limited to cash or marketable securities and numerous others.

62 While the Company may seek such right as a means to control the composition of its stockholders and avoid having undesired partners forced upon it, Investors often will strongly object to this provision as an undue restriction and potential delay on their ability to obtain liquidity at a favorable price. To the extent that the Investors agree to such a provision, customary exclusions will include transfers to limited partners and affiliates, transfers of less than a certain percentage of each Investor's initial holdings, and transfers to other Investors. Investors agreeing to such provisions often will insist that the right be a right of first offer rather than a right of first refusal. Finally, Investors should give consideration to events that ought to trigger the termination of such rights, including, among others, the passage of a certain amount of time.

63 A variety of other matters may be covered in this section of the termsheet, such as the use, or prohibition on use, of press releases and other public communications regarding the transaction, such as use of logos on the Company's and/or Investors' websites.

64 Necessary only if this is a later round of financing and not the initial Series A round.

any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this no-shop obligation and, prior to [________], closes any of the above-referenced transactions [without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction], then the Company shall pay to the Investors $[_______] upon the closing of any such transaction as liquidated damages.][65] The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [_________], as lead Investor, without the written consent of the Investors.]]

Expiration: This Term Sheet expires on [_______ __, 200_] if not accepted by the Company by that date.

EXECUTED THIS [__] DAY OF [_________], 200[_].

[SIGNATURE BLOCKS][66]

---

[65] It is unusual to provide for such "break-up" fees in connection with a venture capital financing, but might be something to consider where there is a substantial possibility the Company may be sold prior to consummation of the financing (e.g., a later stage deal), or if the Company is being solicited by multiple prospective investors and the lead Investor does not trust the Company not to shop its deal.

[66] To avoid confusion and potential arguments that a contract exists prior to satisfaction of conditions of the investment being satisfied it is generally recommended that a term sheet not be signed. Where parties believe that there is a psychological benefit to have the term sheet be signed, or where the parties agree to limited binding provisions, the document is signed. In such a situation it is important to ensure that the non-binding language in the introductory paragraph to the term sheet be included in the document, preferably at the outset or immediately preceding the signature blocks.