NEGOTIATING START UP FINANCING
THE TERM SHEET

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PRESENTER INTRODUCTIONS AND BIOGRAPHIES

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VENTURE CAPITAL
WHAT IS IT AND WHO PROVIDES IT ?

- Local Bank
- Angel Venture Capital Firms
- Corporate Investors & Government Grants
- Institutional Venture Capital Firms
- Venture Debt Firms
- Hedge Funds

It's Important To Know Who The Actual People Are, Where They Get Their Money And Why They Are Funded.

VENTURE CAPITALIST OBJECTIVES

- High Risk - High Return Investments
  - 30% Compounded Internal Rate of Return
  - Must Allow For Substantial Failure Rate
- Control Fate Through Direct Involvement
  - Company Management Via BOD
  - Personally Add Value To The Business
- Build And Foster Successful Relationships
- Avoid Write Offs and Downs
- Create Exits

VC Fund Financial Modeling Example (5 Year)

	Single Investment Of $50,000,000 @ 30% CAGR
1	65,000,000
2	84,500,000
3	109,850,000
4	142,805,000
5	185,646,500
	$185,646,500

	$5,000,000 Initial Investment In 10 Companies	Multiple At Exit	Exit Valuation
1	5,000,000	0	0
2	5,000,000	0	0
3	5,000,000	0.15	750,000
4	5,000,000	1	5,000,000
5	5,000,000	2	10,000,000
6	5,000,000	2	10,000,000
7	5,000,000	4	20,000,000
8	5,000,000	8	40,000,000
9	5,000,000	10	50,000,000
10	5,000,000	10	50,000,000
			$185,750,000

RINGING THE VC (INVESTOR) BELLS, HOW DO I GET A DEAL DONE ?

- Understand And Be Sensitive To The VC's Goals And Investment Process
- Know The Skills And Orientation Of The VCs - Seek Out Those That Can Help Build The Business
- Be An "OptiRealist " - *Rationally Demonstrate* How To Maximize The Upside Potential While Minimizing The Downside Risk Of The Business
- Develop A Compelling Business Proposition And Be Prepared To Beat The VC To The Analytical Punch On Every Material Opportunity And Contingency Question That May Arise
- Present A Great Team – "Done It Before" Record Of Success, Technical Leadership And Ready Access To Customers
- Recognize Due Diligence Needs And Be Prepared For Them.
- Demonstrate Exuberance, Leadership And Flexibility.

The Other Side of the Street - What Should You Ask of the VC (Other than for M-O-N-E-Y)

- Vocation Or “Hobby” ? Do They Know Your Business ? Backgrounds, Expertise, And Comparable Deals ?
- VC Firm’s Deal Timetable – Know When To Cut Bait And Move On
- VC Firm Investment Patience And Viability For Subsequent Funding
- Connections - Network For Services And Industry Aid, Customer Contacts, Partnerships And Fund Raising
- Depth Of Involvement – Resolve Up Front Areas And Level Of Involvement - Where Can And Will They Help With The Business And Yet Not Interfere?
- Human Characteristics: Passion, Understanding, Honesty, Likeability…Chemistry!
- Corporate Government - Candid Discussions Of Company Management And Structure
- Enlist The Views Of Your Professionals. Make sure you have a good lawyer and accountant

Terms For The Deal Must be Weighed Against The Above Points – Tradeoffs Are Always Necessary

THE CORPORATE CAPITALIZATION TABLE A QUICK PRIMER-TERMINOLOGY

- Most VC Funded Companies Are C Corporations
  - Accommodates Complex Stock Ownership
  - Enables Easy Integration Exits
- VC Deals Are Typically For Corporate Preferred Equity
- Forms Of Equity And Debt Used By VC's
  - Preferred Stock – Preferences Include Redemption, Liquidation, Dividends, Voting, Conversion, Other Rights
  - Common Stock – Subordinate To Preferred Stock
  - Warrants (For Preferred Or Common Stock)
  - Options (Generally For Common Stock)
  - Convertible Debt – Bridge Loans

VALUATION
THE MOTHER OF ALL STICKING POINTS

- Numerous Methods For Valuing A Businesses Exist, Few Actually Apply To A Pre-Revenue Venture Stage Company.
- Examples:
  - Discounted Income Or Cash Flow Methods
  - Market Comparative Approaches (Sample And M&A Methods)
  - Asset Based Modeling
  - Excess Earnings
  - … And All With Variant Metrics And Analytical Calculations For Asset Values, Discounts For Liquidity, Etc.
- Bottom Line, The Most Widely Used Valuation Method In The Private Equity World Is A Version Of DCF With The Discount And Cash Flow Method Analysis Translated In Multiples Of EBITDA, With Appropriate Add-backs And Balance Sheet Adjustments.
- Startups Without Customers Or Earnings Must Establish The Value Of Their Time And Effort To Create Something Unique As Compared To The Cost To Start And Get To The Same Point With Different People.

EBITDA - Earnings Before Interest, Taxes, Depreciation and Amortization

The Term Sheet- CONGRATULATIONS!

Non-Binding Representation of Terms Under Which the VC will Invest or Lead a Syndicate to Invest in the Venture.

Some of these provisions will end up in the "Charter" some in the agreements among the company, founders and VC investors, but the language in the term sheet, which may refer to those documents, is the same or similar regardless of how the term is executed.

TERM SHEET HOT TOPICS

- Company Valuation
- Company Ownership
- Stock Options
- Liquidation Preferences
- Use Of Proceeds
- Redemption Rights
- Anti-Dilution Rights
- Information Rights
- Voting Rights

NEGOTIATING VALUATION – Series A

- Basic VC Rules - Facts Of Life
  - Start All Deals Expecting 10X Return
  - Use "Rule Of Thumb" High Growth Company Exit Values Can Be Estimated At 2 - 2.5X Revenue
  - The Revenue You Portray In Your Business Case Will Effect Your Pre-Money Valuation – Exits Are Assumed To Be In Year 4 Or 5

Case 1
- $12M Revenue = $30M Company Exit Value
- $21M Return / 10 = $2M Investment
- Company Pre-Money Value Could Be Around $1M

Case 2
- $40M Revenue = $100M Company Exit Value
- $70M Return / 10 = $7M Investment
- Company Pre-Money Value Will Be Around $4M

Case 3
- $85M Revenue = $212M Company Exit Value
- $150M Return / 10 = $15M Investment
- Company Pre-Money Value Will Be ~ $8M

THE AGREED CAPITAL OWNERSHIP TABLE PRE And POST CLOSING

__Sample Language:__

"The Company's capital structure before and after the Closing is set forth below:

[then there will be a tabular presentation of the number of shares of each class of stock issued, warrants and options for each class, debt identifying secured and unsecured and that held by affiliates]"

- The Cap Table Spells Out Pre And Post Money Company Valuation, Stock Price, Ownership And Stock Class Structure.

- The Cap Table Is Often The Basis For Substantial Negotiation Since It Establishes The Split Between What The Employees And Investors Own.

NEGOTIATING OWNERSHIP & PRICE
Hypothetical Series A Capitalization Table

CAPITALIZATION TABLE	Preferred Series A	Preferred Series A Warrants	Total Preferred Shares	Preferred Percent	Common Shares	Common Warrants	Options Granted	Total Common Shares	Total Shares	Fully Diluted %
Professional Investor 1	1,000,000	100,000	1,100,000	31.88%					1,100,000	18.84%
Professional Investor 2	1,000,000		1,000,000	28.99%					1,000,000	17.12%
Professional Investor 3	1,000,000		1,000,000	28.99%					1,000,000	17.12%
Founder 1	50,000		50,000	1.45%	375,000			375000	425,000	7.28%
Founder 2	40,000		40,000	1.16%	375,000			375000	415,000	7.11%
Founder 3	30,000		30,000	0.87%	375,000			375000	405,000	6.93%
Friends & Family 1	20,000		20,000	0.58%		10,000		10000	30,000	0.51%
Friends & Family 2	30,000		30,000	0.87%		10,000		10000	40,000	0.68%
Friends & Family 3	40,000		40,000	1.16%		10,000		10000	50,000	0.86%
Friends & Family 4	40,000		40,000	1.16%		10,000		10000	50,000	0.86%
Vendors / Consultants						50,000		50000	50,000	0.86%
Corporate Partners	100,000		100,000	2.90%		50,000		50000	150,000	2.57%
Option Pool							1,125,000	1125000	1,125,000	19.26%
Total Shares Outstanding	3,350,000	100,000	3,450,000	100%	1,125,000	140,000	1,125,000	2,390,000	5,840,000	100.00%

Price Per Share	$0.50	Option Per Share	$0.05
Total Invested	$1,675,000	Total Options + Warrants	21.66%
Pre- Money Value	**$820,000**	**Total Company Ownership**	**40.58%**
Post Money Value	**$2,920,000**	**Total Common Shares**	**40.92%**

Note: Generally, Employee Ownership drops on a B round to around 30%
And drops further on a C round to around 20%

LIQUIDATION PREFERENCE

Sample Language:

"In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows: First pay 1.0 times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock on an as-converted basis."

- Liquidation Preferences Are A Way For Investors To Mitigate Risk. The Idea Being That Upon Sale Of The Company The "Cash" Investors Get Their Investment Back With Interest Before Anyone Else Gets Their Share.

Negotiating Liquidation Preference

Liquidation Preference Examples

Total Series A Investment **$1,675,000**

Preference		Company Purchase Price	Series A Preferred	Series A Preferred Dividend	Total Series A Preferred	Total Common
1X Unlimited Conversion	1X	**$1,675,000**	$1,675,000	$0	$1,675,000	**$0**
	4X	**$6,700,000**	$4,409,346	$396,425	$4,805,772	**$1,894,228**
	8X	**$13,400,000**	$8,367,394	$396,425	$8,763,820	**$4,636,180**
1X w/ 2X Cap & Conv Option	1X	**$1,675,000**	$1,675,000	$0	$1,675,000	**$0**
	2X	**$3,350,000**	$2,430,322	$396,425	$2,826,748	**$523,252**
2.929426	X	**$4,906,789**	$3,350,000	$396,425	$3,746,426	**$1,160,363**
3.385507	X	**$5,670,724**	$3,350,000	$396,425	$3,746,425	**$1,924,299**
	4X	**$6,700,000**	$3,958,048	$396,425	$4,354,473	**$2,345,527**
	8X	**$13,400,000**	$7,916,096	$396,425	$8,312,521	**$5,087,479**

USE OF PROCEEDS

<u>*Sample Language:*</u>

All proceeds from the sale of Series A Preferred Stock are to be used only for working capital of the Company, and no proceeds will be used in the payment of debt of the Company nor to any affiliate (provided, that the Prior Notes and the convertible promissory notes issued in conjunction with the interim debt financing undertaken pursuant to those certain promissory notes issued in the denominations and to the persons described on Exhibit C hereto (the “Bridge Notes") shall be converted into the Series A Preferred Stock as provided above), or in the repurchase or cancellation of the Company’s securities. A detailed budget for the expenditure of the invested funds shall be agreed to by the New Investors at the closing but shall be substantially compliant with the categorical budget attached as Exhibit __. Default in this provision shall be a “Material Adverse Event.”

- This Term Requires The Company To Know Its Needs And Do A Good Job Of Forecasting. The Operating Plan (Budget) Is Often Based On Insufficient Knowledge At This Stage Of Company Development Leading To Disgruntled Investors.

REDEMPTION RIGHTS

Sample Language:
The Series A Preferred shall be redeemable from funds legally available for distribution at the option of holders of at least [__]% of the Series A Preferred 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, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)]

- Redemption Rights Provide A Mechanism For An Investor To Ask For Their Money Back If The Company Has Excess Cash And Is Not Pursuing An IPO.
- Negotiating Tip: Ask To Delete It, Fall Back To Push It Out In Time As Far As Possible. May Also See Redemption Triggered By Insolvency - Will Not Likely Be Enforced And Creates Issues Of Priority And Balance Sheet Accounting issues.

ANTI-DILUTION PROVISIONS

<u>Sample Language (Rare):</u>

*In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula: CP2 = CP1 * (A+B) / (A+C).*

CP2 = New Series A Conversion Price

CP1 = 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 CP1

C = Number of shares of stock issued in the subject transaction]

<u>Sample Language (Typical):</u>

The conversion price will be reduced to [__% of] the price at which the new shares are issued.

- The Idea Is To Protect Current Investors In The Event Of A Subsequent Down Round. The Expectation Is That The Current Investors Will Get A Favorable Price Adjustment.

ANTI-DILUTION RATCHET ILLUSTRATION

1. Private company raises $10 million for 40% of the Company.

	# shares	% owner-ship	Contributed Capital	Basis per share	Post money value	Pre-money value
Common stock	1,264,045	45.0%			$ 11,250,000	
Option reserve	421,348	**15.0%**			3,750,000	
Series A Pfd stock	1,123,596	**40.0%**	**$ 10,000,000**	**$ 8.90**	10,000,000	
Total shares	2,808,989	100.0%			$ 25,000,000	$ 15,000,000

ANTI-DILUTION RATCHET ILLUSTRATION – Cont.

2. Eighteen months later, the same company raises $8 million for 33.3% of the Company in a down round. Option pool % is preserved.

(a) **No ratchet**

	# shares	% ownership	Contributed Capital	Basis per share	Post money value	Change in post money value from first round	Pre-money value
Common stock	1,264,045	27.4%			$ 6,564,706	($4,685,294)	
Option reserve	693,186	15.0%			3,600,000	(150,000)	
Series A Pfd stock	1,123,596	24.3%	$ 10,000,000	**$ 8.90**	5,835,294	(4,164,706)	
Series B Pfd stock	1,540,413	33.3%	$ 8,000,000	**$ 5.19**	8,000,000		
Total shares	4,621,240	100.0%			$ 24,000,000	($9,000,000)	$ 16,000,000

(b) **Full ratchet**: Series A investor receives enough shares to drive original basis down to new share price.

	# shares	% ownership	Contributed Capital	Basis per share	Post money value	Change in post money value from first round	Pre-money value
Common stock	1,264,045	10.0%			$ 2,400,000	($8,850,000)	
Option reserve	1,896,067	15.0%			3,600,000	(150,000)	
Series A Pfd stock	5,266,854	41.7%	$ 10,000,000	**$ 1.90**	10,000,000	0	
Series B Pfd stock	4,213,483	33.3%	$ 8,000,000	**$ 1.90**	8,000,000		
Total shares	12,640,449	100.0%			$ 24,000,000	($9,000,000)	$ 16,000,000

ANTI-DILUTION RATCHET ILLUSTRATION – Cont.

(c) **Narrow weighted average ratchet**: Only pfd stk is included. Series A adjustment: Original Series A issue price per share * [(# old A pfd shares + Value of new B pfd issue at old Series A price) / (# old A pfd shares+ # new B pfd shares)]

	# shares	% owner-ship	Contributed Capital	Basis per share	Post money value	Change in post money value from first round	Pre-money value
Common stock	1,264,045	$\boxed{22.2\%}$			$ 5,325,620	$ (5,924,380)	
Option reserve	854,466	15.0%			3,600,000	(150,000)	
Series A Pfd stock	1,679,116	29.5%	$ 10,000,000	**$ 5.96**	7,074,380	(2,925,620)	
Series B Pfd stock	1,898,814	33.3%	$ 8,000,000	**$ 4.21**	8,000,000		
Total shares	5,696,441	100.0%			$ 24,000,000	($9,000,000)	$ 16,000,000

(d) **Broad weighted average ratchet**: All shares included. Adjustment: Original Series A issue price per share * (# all original shares + Value of new B pfd issue at old Series A price) / (# all original shares + new B pfd shares)

	# shares	% owner-ship	Contributed Capital	Basis per share	Post money value	Change in post money value from first round	Pre-money value
Common stock	1,264,045	$\boxed{24.8\%}$			$ 5,961,368	($5,288,632)	
Option reserve	763,342	15.0%			3,600,000	(150,000)	
Series A Pfd stock	1,365,244	26.8%	$ 10,000,000	**$ 7.32**	6,438,632	(3,561,368)	
Series B Pfd stock	1,696,315	33.3%	$ 8,000,000	**$ 4.72**	8,000,000		
Total shares	5,088,946	100.0%			$ 24,000,000	($9,000,000)	$ 16,000,000

INFORMATION RIGHTS

<u>*Sample Language:*</u>
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, and other information as determined by the Board; (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 the upcoming fiscal year; and (iii) promptly following the end of each quarter an up-to-date capitalization table, certified by the CFO and CEO.

- Expect All Investors To Have These Rights. Can Create Conflict Of Interests.
- Must Provide All "Important" Company Information To The BOD And Select Investors. Should Reach Agreement Before Closing Who Will Get What.
- Need Books In Order And Accurate Information. The Best Way (Other Than Lying) To Get Off Track With The VC Is To Deliver BS Numbers Or Not Have Them Available When Expected.

VOTING RIGHTS
FUNDAMENTAL AND PROTECTIVE PROVISIONS

Sample Language:
So long as [insert fixed number, or %, or "any"] shares of Series A Preferred are outstanding, the Company will not, without the written consent of the holders of at least [__]% of the Company's Series A Preferred, either directly or by amendment, merger, 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 manner adverse to the Series A Preferred];[(iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences or privileges senior to or on parity with the Series A Preferred, or increase the authorized number of shares of Series A Preferred; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, [other than 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;] [other than as approved by the Board, including the approval of [_____] Series A Director(s)]; or (v) create or authorize the creation of any debt security [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 [________] Series A Director(s)]; (vi) increase or decrease the size of the Board of Directors.

- In English: The VC will control subsequent events that effect a financing or recap of the business, selling the business, or affect their rights. These things can be further qualified by negotiation. Example, additional shares if at an up round might have a waiver of the approval rights.
- Necessity and Rationale. FYI, *as a matter of law in most states 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 entire class of all Preferred Stock, then the holders of that series are entitled to a separate series vote on the amendment. This is a control mechanism for circumstances were the VC does not won a majority of the common stock*. I have not seen a deal done where these provisions in some form were not included.

VOTING RIGHTS
NON FUNDAMENTAL / DIRECTORS

Sample Language :
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) the Series A Preferred as a class shall be entitled to elect [________] [(_)] members of the Board [advisory directors options] (the "Series A Directors"), (ii) as provided under "Protective Provisions" below or (iii) as required by law. 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 . In the event of the company's insolvency or any "Material Adverse Event" the entire Board of Directors shall be elected upon demand by majority consent of the Series A Preferred Stock.

- In English: Class voting means. "As a single class." How many board seats [good discussion to have with the VC on the chemistry issue]. What is required by law. Waiver on class right for additional shares.
- Necessity and Rationale. Never get a deal done without board seats. Majority is possible. All in syndicate may want observer rights. Governance issues are critical to VC's and becoming more so. Material events might include financial performance failings, loss of a key executive, litigation of various types, etc. All negotiable.

OTHER TERMS

- Yes there are more! Things covered include:
- An expiration date-and a timeline for processing the due diligence.
- Indemnity of the VC for statements and business of the company prior to closing.
- Indemnity of VC directors and provision of D&O insurance.
- Key man insurance requirements.
- Press releases-terms negotiated but approved by VC.
- Non assignability of the term sheet and rights.
- Limits on affiliate contracts.
- Hiring limits.
- Expense protocols.
- Particular deals may have particular requirements, SBIC's and religious related/backed funds may have requirements.
- Selection of professionals

See The Appendix For More Term Definitions

OTHER THINGS TO KEEP IN MIND - PRF's ROLE

- If You Start A Company Based On Purdue IP You Must Negotiate Terms With PRF
- All Investors Will Want An Agreement In Place Prior To Negotiating An Investment
- Typically In A Start-up PRF Will Look For:
  - Royalties On Gross Revenues Range From 3 To 10 Percent
  - Equity 10 To 25 Percent Depending On Dilution Rights

“*THEY WOULD NOT KNOW A GOOD DEAL IF IT HIT THEM IN THE FACE*” Anonymous VC

WHAT IS A GOOD VC DEAL?

REASONABLE TERMS

For an Early Stage Company With A Seasoned Team At The Proto-Type or Clinical Trial Product Point Of Development With No Revenue Or Earnings

- Enough Funding To Ramp And Run The Company For A Year (To A Material Funding Event) - Agreement On Intentions For 2nd Round
- $1- $5M Valuation Depending Upon The Opportunity
- Around 40% Ownership Including Stock Option Pool
  - CEO 5-10%,   VP Eng 3-5%,   VP Sales 1-3%
  - Greater Ownership If Employees Buy Preferred Stock
- Liquidation Preferences Of 1X With Unlimited Participation Upon Conversion – Could Be 2X Reduced To 1X On B Round
- 5 Years or More For Redemption Rights
- Voting Rights – Preferred Share Holders Will Have Full Control

SUCCESS – Prosperity Comes From :

- Breakthrough Product Inventions
- Addressing Critical Customer Needs
- Capturing Market Leadership Positions
- Maintaining High Financial Growth Rates
- Creating Above Average Investment Returns
- Producing Multiple Multi-Millionaire Employees

You Have The Opportunity And The Environment To Achieve Great Success

The End

Appendix

STRUCTURE AND IDENTITY

Sample Language:

Issuer: [name of company] (the “Company”), is a corporation [in formation, LLC, LP].

Investors: Big Hitter Resources, Inc. (“BHR”), Find-a-Gem Venture Fund or its affiliated funds (in any case, “Stone”), Fortune Teller Investment Partners I, LP (“FTIP”) and certain other investors acceptable to BHR, Stone and FTIP.

Type of Security: Series A Convertible Preferred Stock [or one of the options described earlier].

Financing Amount [Timing of Advances]: Here the term sheet would set out who is putting up what, the number of shares, and when they are doing it. May be lump sum or may be a schedule attached for milestone funding.

- Identity of the issuer-form and state of organization elements. Who intends to invest in a syndicated deal would be laid out. Common to just state up front for context what the security will be (although the remainder of the term sheet is devoted to telling what the “bundle” is.)

BOARD OF DIRECTORS-INITIAL

Sample Language:

At the initial Closing, the Board shall consist of [______] members comprised of (i) [Name] as [the representative designated by [____], as the lead Investor, (ii) [Name] as the representative designated by the remaining Investors, (iii) [Name] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [___] person(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].

- Very typical to stipulate who will be seated and have resolutions to effect the seating at the closing (people again). Negotiated for the closing and then reelected in accordance with the voting provisions. Will likely have a board meeting to ratify a budget, affirm officers, schedule subsequent meetings, etc. either at or immediately after the closing.

- May also stipulate disinterested approval of the various documents required for the deal like Buy-Sell and Co-Sale Agreement, Registration Rights Agreement, Proprietary Inventions Agreement, Employment Agreements. May also provide for committees to establish compensation, audit and a budget committee that will be required to permit or not variances from an agreed budget [are also other provisions you might see in a term sheet for these limitations].

EMPLOYEE SHARES AND OPTIONS

Sample Language Option Pool:
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.]

- For purposes of a term sheet, this language may be OK. The numbers here are all negotiable-keep alignment of interests in mind. This is a very critical part of negotiation with the VC. You need to know what is required to get and keep good people and need to communicate that to the VC.

FOUNDERS SHARES

Sample Language:
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.

- This provision and similar ones are not typical, but they do show up. Obviously to be bound to sell back shares owned is not exactly an incentive for doing the work necessary to maximize equity value. If a provision like this is in the term sheet, the VC needs to support the rationale for it and it should be supported by an analysis of what is "cost" and related terms to establish some fairness if the VC wants to actually enforce these terms. One thing that might make sense is tying the ownership to default under the key employee covenants and that and option waivers are common in final documents if not in the term sheet. Do not be surprised to see other provisions to vest shares of members of the management team over time or tied to milestones.

KEY PERSONNEL COVENANTS AND ASSIGNMENT OF INVENTIONS

Sample Language:
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. Each current and former Founder, employee and consultant with access to Company confidential information/trade secrets, and others selected by the Investors will enter into a non-disclosure and proprietary rights assignment agreement in a form reasonably acceptable to the Investors, including documents sufficient to effect the outright assignment to the company of all intellectual property used or relied upon by the company and all business opportunities of such persons that relate to the company's business.

- Put this in context—this is a VC investment and in all likelihood IP is a critical component. VC's will not generally finance licensed IP. Covenants against competition or more or less enforceable depending on the state. Non solicitation and confidentiality covenants are generally enforceable anywhere.

CONVERSION RIGHTS OPTIONAL TO THE VC

<u>Sample Language:</u>

The Series A Preferred initially converts 1:1 to Common Stock at any time at the option of the holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under "Anti-dilution Provisions." In addition, the conversion ratio shall be adjusted upon the happening of certain events described on Exhibit _, provided that at no time shall the Series A Preferred convert to less than _% of the equity ownership [common stock] of the Company"

- In English: How it works without an adjustment event. Explain adjustments-why anti-dilution. Favorable adjustments for hitting those expectations the Company will so well manage.
- Necessity and Rationale. Correlation to Valuation, Interplay to the agreed Preference.

CONVERSION RIGHTS MANDATORY FOR THE VC

Sample Language:

Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a [firm commitment] underwritten domestic [or foreign] public offering with a price of [___] times the Original Purchase Price (subject to adjustments for stock dividends, splits, combinations and similar events) and [net/gross] proceeds to the Company of not less than $[________] (a "**QPO**"), or (ii) upon the written consent of the holders of [__]% of the Series A Preferred, or (iii) upon an offer to acquire the business at an enterprise value exceeding [formula], or (iv) upon [other financing/IPO terms].

- In English: Public Offering-underwritten or best efforts. Realistic, other offerings. "Unsolicited" bid. Syndicated deal. Other events.
- Necessity and Rationale. Important provisions as you have to envisage subsequent rounds and exit opportunities. In most cases, VC's can block an exit-you may want to negotiate some flexibility.

PAY TO PLAY - HUGE WITH A SYNDICATE

Sample Language:
Unless the holders of [__]% of the Series A elect otherwise,] on any subsequent down round all [Major] Investors are required to participate to the full extent of their participation rights, unless the participation requirement is waived for all [Major] Investors by the Board [(including vote of [a majority of] the Series A Director[s])]. All shares of Series A Preferred 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.

- In English: If you need more money and cannot get it elsewhere, the existing VC's suffer a penalty of they do not provide the capital…as long as someone else does (it is self-enabling in that regard). *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* and that is fairly typical where this provision is in a term sheet. Board vote and fiduciary responsibilities.
- Necessity and Rationale. Forces existing VC's to be "hooked money" and builds in the expectation for add on investing. VC's do not like pay to play provisions, but they are very useful. Remember, no matter how hard you try, unless you overfund the first round in a pre-revenue budget, you will likely need more equity capital.

REGISTRATION RIGHTS - page 1

Sample Term Sheet Language:

- *Demand Rights: Upon earliest of (i) [three-five] years after the Closing; or (ii) [six] months following an initial public offering ("**IPO**"), persons holding [__]% 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).*

- *S-3 Rights: 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 [two] per year.*

- *Piggyback Rights 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.*

REGISTRATION RIGHTS - page 2

Term sheet sample continued:

- *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 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 Investors, pro rata, based on the number of shares held.*

- Background-why have this? SEC requirements. Detail may not be in the term sheet as above, may just state "typical piggyback" etc.

- In English: How does it work and some of the terms. Demand are really not appropriate for a pre-revenue business and should be countered as cumbersome and too speculative to have meaning.

- Necessity and Rationale. No one gets out alive, unless I do first! For discussion here analogue is "RAP."

PREEMPTIVE RIGHTS

Sample Language:
All Series A Preferred Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances in connection with acquisitions by the Company). In addition, should any Investor choose not to purchase its full pro rata share, the remaining Investors shall have the right to purchase the remaining pro rata shares.

- Seems innocuous-it is not. Could be stifling, and at the same time is another of the provisions that means little depending on what is in the protective provisions. Might ask the VC what benefit seeking by the terms ("maintain equity" will be the answer); if VC is acquiring a minority position on an as converted basis, the provision does not hurt, but in practice meaningless if new money says it is.

RIGHTS OF FIRST REFUSAL

Sample Language:

Company first and Investors second, have a right of first refusal with respect to any shares of capital stock of the Company proposed to be sold by Founders [and employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock)], with a right of oversubscription for Investors of shares unsubscribed by the other Investors. 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.

- For a private company, QED end of ballgame (remember the getting out alive thing)-your founder or employee shares cannot be sold as long as the VC owns theirs. Explain impact of the provision is more stifling than most similar provisions-minority stock in a private company is not a house. Having said that, this is going to be in the term sheet 999 times out of 1000.

DRAG ALONG

Sample Language:
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 in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred, approved by [the Board of Directors] [and the holders of a [majority] [super majority] of the outstanding shares of Preferred Stock, on an as-converted basis].

- Effect is to force the non-VC's to sell the company when the VC thinks there is a good deal on the table. Can negotiate many reasonable limits, but need to be thoughtful in that-like price, formulaic limits, employment requirements.

- Are also "Tag along" rights and co-sale provisions that enable the non-VC's to get carried in any deal they promote for sale of their interests—need it if there is a majority investor among the VC's or if they as a group own a majority.

CONDITIONS TO A DEAL

Sample Language:
The definitive terms for the investment shall be set forth in an acceptable form of Stock Purchase Agreement prepared by counsel to the Investors. Standard representations and warranties by the Company and representations and warranties by Founders regarding [technology ownership, litigation, etc.] shall be incorporated into the Agreement which shall be signed by ___ and ___. The investment is subject to what we consider to be 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 of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, and an opinion of counsel to the Company. Specific conditions also shall include the acquisition of key man insurance, the delivery of an environmental certificate of ___ regarding ___, estoppel certificates from ____, and ______.

- The term sheet is simple compared to the "SPA." The Representations and warranties will be comprehensive and are intended to tell the VC he is getting what you said he would get. In most deals, individuals are put on the line for the representations, or at least those where that is a fair expectation.
- The investors have a "diligence" out which pretty much assures them that they can kill the deal for anything negative or unanticipated-the term sheet is intended to be non-binding remember.

NO SHOP AND EXCLUSIVITY-A BINDING PART OF THE TERM SHEET

Sample Language:
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 [__] 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 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.][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.

- Actually, it is unusual to provide "break-up" fees in connection with a venture capital financing, but it is done, especially when there are expenses incurred to get to the term sheet and beyond stage. Tip here is that the company needs to feel pretty confident about the deal and its new partners before signing the term sheet. Also good faith with those who have gone so far to make a deal is in the company's interest—the next guy is not going to want to do business with someone who baled out on a prior deal. If there are potential valuation events contemplated during the No-Shop period those may need to be dealt with here and in the valuation discussions.

DISPUTE RESOLUTION

Sample Language:
The definitive agreements shall be interpreted and enforced under, and all questions relating thereto shall be determined in accordance with the laws of the State of Massachusetts. All disputes among the parties shall be submitted to and resolved in a final and binding arbitration proceeding under the commercial arbitration rules of the American Arbitration Association (AAA) conducted within 50 miles of Boston Massachusetts, and the award from which may be enforced in any state and federal court with personal jurisdiction over the parties or to which they submit. The arbitration shall be conducted employing the expedited arbitration procedures of the AAA, before a single arbitrator selected as provided in the commercial arbitration rules of the AAA

- Why? If they do not suggest such a term, you should. The nature of disputes among VC's and the company, and among the VC's themselves are not generally suitable to resolve in litigation. Add arbitrator qualifications.

EXPENSES OF THE DEAL

Sample Language:
The Company will reimburse the Investors in an amount not to exceed a total of $___,000, unless otherwise agreed upon, for their out-of-pocket expenses and legal expenses associated with the transaction contemplated hereby, payable upon presentation of invoices whether or not a closing is effected (and if the closing is effected, such expenses shall be paid at the closing), provided that the Company shall have no such reimbursement obligation if the Investors elect not to proceed with the transaction contemplated by this term sheet, unless the Investors have learned of a material adverse difference in the business or prospects of the Company from that known to them at this time

- Another of the binding provisions in a term sheet. This is always negotiable, but particularly where there is syndicate, the lead is going to want expenses paid.
- Might also see other expense provisions for reimbursement of board attendance and monitoring expenses in a term sheet. Key will be to put a fence around the exposure to the company.

DIVIDEND RIGHTS

<u>*Sample Language:*</u>

The Series A Preferred will carry an annual [__]% cumulative dividend [compounded annually], payable upon a liquidation or redemption. For any other dividends or distributions, participation with Common Stock on an as-converted basis.

- In English: Rate, Cumulative, Non-Cumulative, Compounding, As Converted, Payment, PIK Options
- Necessity and Rationale. Correlation to Liquidation Preference, Fixed Return for VC Investors.