Venture Capital Investment Terms - Comments to the NVCA Term Sheet

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Valerie C. Mann[1]

The National Venture Capital Association (US) has prepared various model venture capital documents for use in the industry, including a term sheet (the "NVCA Term Sheet"). These model legal documents are available at www.nvca.org. The American Bar Association has further commented on the provisions in the NVCA Term Sheet, in particular adding commentary including outlining any differences between the California corporations law and Delaware law. A copy of the ABA comments to the NVCA Term Sheet is attached as Exhibit I to this paper.

As a further, review, the following covers the NVCA Term Sheet from a Canadian perspective. The following outlines the key terms for a venture capital investment drawing on the provisions of the NVCA Term Sheet. The following comments and review were delivered at the Ninth Annual IT.Can Conference in Montreal, Quebec on October 27, 2005.

1. General Comment on NVCA/US Terminology. The NVCA Term Sheet refers to certain terms, and is structured in a manner that is a little different in Canada than in the US. Although many of the terms that are outlined in the NVCA Term Sheet apply in Canadian deals and cross-border deals, there are some differences. For example:

   ◊ those matters that are set out under the heading "Charter" in the NVCA Term Sheet will be included in the Articles of a company in Canada, but some of the items included in the "Charter" are more likely to appear in a form of shareholders' agreement;

   ◊ stock purchase agreement is a subscription agreement here. The subscription agreement will contain not only representations and warranties of the investee company, but also of the investor with respect to certain required securities (private placement) issues;

   ◊ "investor rights agreement" is a shareholders' agreement; and

   ◊ Right of First Refusal/Co-Sale and Voting Agreement will all be incorporated into the terms of the shareholders' agreement.

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2. Structure of Investment

(a) *Convertible Preferred Shares* or *Convertible Debt*. In general, a VC will invest by way of preference shares or debt convertible into shares. However, depending upon the terms associated with, in particular, convertible preferred shares, an investee company may find that it ends up with an instrument that will be treated for accounting purposes as a debt instrument. That will affect the investee's P&L statements which will have implications for its business activities and, possibly, future financing activities. Whether convertible preferred shares are equity or debt (or both) for tax purposes will depend on the 'substance of the contractual arrangement'.[2]

In general, the 'philosophical debate' of whether an investor should be given the preferential protective provisions of a preferred share as well as the upside is over. Investee companies who choose to fund via the venture capital route may, if they are fortunate, have a number of interested VC's vying for the investment, but they will be debating valuations, not whether or not a preferential security will be issued.

(b) *Cross Border Tax Concerns*. Canadian investee companies will, if they can, want to maintain the favourable tax treatment afforded CCPC's[3] which will allow the entity to continue to have access to SR&ED[4] dollars and will result in more favourable tax treatment of employee options and to Canadian shareholders. A US investor may throw off the tax status of the investee company with its investment. However there are ways of structuring the investment by way of exchangeable shares that will ensure that:

(i) no non-resident holds shares with sufficient voting rights to permit the non-resident to elect a majority of the board of investee company (or have the contractual right to do so);

(ii) no group of non-residents can have effective control of the investee company; and

[2] Canadian Institute of Chartered Accountants Handbook paragraph 3861.

[3] Canadian Controlled Private Corporations

[4] Scientific Research and Education Tax Program - ∞

(iii) no non-resident can trigger an acquisition of shares that would give the non-resident voting control (in a manner that would be deemed to have been exercised from the outset).

Option holders have to be considered in this structure and in the numbers of shares outstanding for the purposes of determining residency.

To illustrate a possible structure, a US investor can invest through a US Corp (e.g. it invests in preferred shares in US Corp and US Corp invests in preferred shares of investee company with share attributes that are the same, except that with respect to votes, the preferred shares in US Corp will entitle the holders to that number of votes equal to the lesser of the percentage of votes to which the investor would indirectly be entitled on an as converted basis and 50% of the votes less the number of votes exercisable by other non-resident shareholders on a fully diluted basis. If necessary, you can also have non-US option holders hold through a US company that in turn holds an interest in the investee company, with an exchange right of options to purchase investee company shares for options to purchase US company shares.[5]

While this creates a level of complexity in both the structure of the investment (and therefore cost) the benefits of continuing to access not only SR&ED tax credits but, in particular, refunds, may make this complexity worthwhile.

(c) *Milestone based investment.* The ABA comments on the NVCA Term Sheet alternative of milestone based investments by VC's, outlining that such investments may be difficult. Structuring the milestones in a clear enough manner so that there is no ambiguity as to whether or not they can be met is only one of the difficulties. The other difficulty, particularly from the perspective of the investee company is the bright-line test associated with milestones. If an investee company comes very close to its milestone but does not quite reach it, then there are no further dollars available to complete the milestone. Having said that, an investor will want to ensure that an investee uses the initial infusion of cash appropriately and so further rounds will be dependant upon demonstrable ability to meet milestones. Milestone investments are more likely to be in earlier stage investments and in certain industries, e.g. life sciences.

[5] There is no guarantee that the Canada Revenue Agency would not still, even with the above structure, still find that the investee company no longer qualifies as a CCPC.

3. Terms of Investment:

The following terms are 'givens' in a VC investment, particularly, with a US-led investment. However, while most term sheets will contain these provisions, many of them will have some areas of negotiation. They are set out below under two headings – those terms that are included in an investee company's articles (or other similar constating documents, depending upon jurisdiction) and those terms that are included in a shareholders' agreement. The following also assumes that the investment is being made by way of convertible preferred share.

(a) The following terms will be reflected in constating documents:

(i) *Voting Rights*. The preferred shares will always vote with commons on an 'as-if' converted basis. They, will, however, also have separate class rights. The NVCA Term Sheet suggests that the Charter will essentially contain an override to certain matters that shareholders of a particular class would otherwise be entitled to vote on. The ABA comments that, under California law, you cannot alter class rights without a special resolution of the affected class. This issue also arises in Canadian law, where the articles cannot eliminate the right of a class to vote on certain matters.[6]

(ii) *Redeemable.* If the preferred shares are redeemable by the investee company, the right will not be available to the investee company until the expiry of a certain period, and may also expire after a certain period. If the shares are redeemable, then both the investee company and the VC will have to consider and negotiate not only the multiple for the redemption right but also whether: (i) fewer than all of the preferred shares can be redeemed; and (ii) whether the full redemption right is paid out in full or on a payment schedule and if the latter, what the payment schedule is and what security might exist for it if any. In addition, if negotiating redemption rights, consider whether the investor will require a retraction right (see below paragraph 4(b))

(iii) *Dividend Rights.* Investee company's position will be to want to have the preferred shares receive dividends pro rata with common shares.

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[6] *Business Corporations Act* (BC) – Section 61 A right or special right attached to issued shares must not be prejudiced or interfered with under this Act or under the memorandum, notice of articles or articles unless the shareholders holding shares of the class or series of shares to which the right or special right is attached consent by a special separate resolution of those shareholders.

However, more likely that the preferred shares will have dividend rights that are in preference to the common shares. Whether they have cumulative or non-cumulative rights will depend upon the valuation calculation. For example, if the preferred shares have cumulative dividend rights of 8% per annum, payable on liquidation, then the liquidation preference will, over a period of time increase from the otherwise negotiated multiple (see subparagraph (iv) below). Some other issues to consider:

◊ after the payment of the preferred return, consider whether the preferred shares also share in the dividend rate with the common shares, for example, sharing pro rata entitlement with the common shares after the payment of its preferential return.

◊ consider the implications of multiple classes of preferred shares – e.g. non-cumulative dividends of 8% payable to Class B's *before* Class A Preferreds and before common shares.

◊ what rate doe each class of preferred share get?

(iv) *Liquidation Right*. The articles will contain provisions regarding liquidation events such as winding up, liquidation, dissolution. Preferred shares will be granted a preferential liquidation right. That preferential right might be negotiated along the following lines:

◊ Preferred shares are either fully participating, non-participating or capped participating. Fully participating preferred shares will get their preferred amount out first, and then participate rateably with the commons. This is the best situation for investors, although the company will argue it is 'double-dipping'. Capped participating will set a rate for pro rata participation up to a specified level and then participate with commons up to a particular return. Generally speaking, that cap is a 1X multiple, although in Series C and D rounds that multiple might, in some circumstances, increase to a 2X to 3X multiple.

◊ Deemed liquidation events on: (i) sale of substantially all the assets; and/or (ii) a change of control. An acquisition is an exit event, so should the investor convert to common or get a preferential return first and then participate with commons on value of sale? A change of control that results from a future financing however, would mean the initial investors cash out even though it is not a defined exit event. The ABA comments to the NVCA term sheet exempt this type of change of control (one resulting from a future financing) from the deemed liquidation provisions.

(v) *Conversion*.

A. The preferred shares will always have a right to convert to common shares, generally on a 1:1 basis, subject to certain adjustments (anti-dilution protections described in more detail below).

B. In addition to a right to convert, there will be certain events that trigger a conversion (Automatic Conversion):

I. if there is an initial public offering of the investee company's shares provided that the Automatic Conversion will only occur if the IPO meets certain criteria including that the proceeds realized from the offering result in gross proceeds to the Company of no less than a minimum threshold, that the shares are listed for trading only on certain exchanges, and that the shares are issued at a multiple of not less tha a particular multiple of the issue price;

II. if the holders of a majority of the class of Preferreds vote to convert; or

III. on certain future financing rounds where "pay-to-play" provisions exist (see below for further comment on "pay-to-play" provisions).

(vi) *Anti-Dilution*. The famous ratchet. The Canadian experience in the down-market did not result in the same degree of draconian ratchet provisions as the US. However, a weighted-average anti-dilution provision is common.

◊ *Weighted Ratchets.* Broad-based ratchets are typical; resulting in the effective price after the down round that is a lower price averaged over the new and previous round (total investment in both rounds divided by the number of shares of both rounds, before adjusting for the ratchet shares).

◊ *Full ratchets* only in really bad investing climates but, while protecting early round investors, it means that later stage investors when the company needs it most, will see the full ratchet as a negative. An additional consideration with this type of investor protection is consideration for the Founders and management. Consideration should be given to what may need to be done to keep them incentivized, such as re-loading their options.

◊ *What's excluded?* There are two sides to the anti-dilution equation and equally important are those matters which need to be excluded Shares issued to employees under approved stock option plan (always); subdivision of shares etc. (always); securities issued under already issued convertible securities. The NVCA term sheet also includes non-financing share issuances, e.g. equipment financing or banks (do not see this in Canada). The ABA adds others (particularly important if you have to diminish the potential impact of a ratchet) such as "strategic and not a financial nature" (hard to control); securities issued to a target co. as part of the consideration (would add that this is a major event that the investors will want some say in pursuant to a shareholders' agreement and will participate in at the board level); and securities that are essentially not covered by the protective provisions (in unanimous shareholders' agreements, all the shares will be covered).

◊ *Inter-connected parts.* Consider 'pay-to-play' provisions ('old' investors with ratchets have to participate in the new financing to trigger the issuance of ratchet shares)(see below) or weighted average anti-dilution provisions connected with more extensive liquidation provisions (the pessimist's view - at some point, liquidation is the next step after a severe downround). Future round investors may put pressure on initial investors with anti-dilution protection to drop or change their protective provisions.

(vii) *Protective Provisions.* Can be in Articles, but can also be in shareholders' agreement. Requirement for a class vote for any major transaction, anything that alters not only its own class rights (which would require a vote in any event) but any other class; redemption or repurchase of shares; changes board size or composition; issuance of any dividends; commitment to any debt (over a particular amount)[note that other than those matters that deal with the Articles or share rights, size of board or nominations, decisions such as payment of dividends are director decisions and would appear in a shareholders' agreement if the shareholders are to fetter the directors' discretion] .

(b) Reflected in Shareholders' Agreement:

(i) *Board Participation.* Board size/composition/quorum. Board that includes investor representatives. Certain number of nominees for a particular class (e.g. A Preferreds) to sit on the board. Could also have board related rules including number of meetings and committees as well as disclosure e.g. the company will prepare and table every quarter a summary of statutory remittances, source deductions made, notice of litigation, and, if applicable to type of company (ie a concern), environmental compliance.

(ii) *Information Rights.* Minimum threshold of investment (e.g. 5%) will entitle investor to monthly/quarterly financial statements (the investors are entitled regardless of size to annual financial statements unless they waive (whether voting shares or not) the right to receive such statements)[7] Also – budget information, cap table and access?

(iii) *Major Decisions*. Certain matters that would otherwise be director or management decisions can require shareholder input. Selling assets, taking on debt and/or granting security interests in assets; management-related decisions including hiring/firing of senior/executive officers; changing the business of the company; selecting an underwriter for IPO or financial advisor for sale.

(iv) *Registration and Corresponding Rights Under Canadian Securities Laws.* Demand registration rights (confirm if there is a minimum amount raised before this kicks in; how many times company must effect this right and 'blackout' period); piggyback registration (subject to rights of company and underwriters to reduce the number proposed to be registered (not to exceed an agreed upon amount).

(v) *Pro Rata Participation Rights*. Also known as 'pre-emptive rights' here[8]. Future equity offerings, investors can participate pro rata (note –

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[7] *Business Corporations Act* (BC) section 199

[8] Until the change in the BC *Business Corporations Act*, these rights were statutory for a private company. Those provisions have been removed.

assuming conversion of all preferreds to commons and, as ABA points out – options and warrants). Also right to purchase any shares not taken up by pro rata right exercise of other investors.

(vi) *ROFR's*. The NVCA Term Sheet contemplates a right of preferred shareholders to acquire Founder common shares. Typically, include these provisions here in the 'restrictions on transfer/right of first refusal' sections of a shareholders agreement. Term sheet might set out the basic requirements for operation of the ROFR e.g. what time frame for exercise, whether right-holders can acquire more if not all taken up (e.g. two rounds).

(vii) *Co-Sale/Drag Along/Tag Along Rights.* The NVCA Term Sheet puts these rights in a right of first refusal/co-sale agreement. This would be in a shareholders' agreement with the investors and founders; but consider drag along rights in the Articles (e.g. percentage of shareholders on a fully diluted basis – 66 2/3%) can require all shareholders to sell. Also consider implications in Option Agreements – they should be part of the drag-along. Also consider in a tag along (or piggy back) two separate thresholds – e.g. a lower one for Founder (or identified key employee/officer) shares (small percentage sold by such person will trigger the Investor tag along) versus a general tag along right e.g based on change of control.

(viii) *Employee Matters.* Set aside a certain portion, or recognize an already established, employee stock option plan. Key person insurance? Requirement (could be a condition precedent) that each [key] employee has entered into employment agreements/non-competition/non-solicitation agreements/confidentiality/assignment of IP agreements. Have to determine who 'key' is – and it may be more than the founders and/or the senior executives.

4. Negotiated Provisions:

(a) <u>Pay to Play</u>.

(i) *How we got there*: With a difficult tech environment, down-rounds became not only more common, but a greater issue at the time of an initial VC round. The NVCA reported in 2004 that 23% of transactions were downrounds (17% being flat, 41% being up) and 47% of first rounds included 'pay-to-play'. Investors, without an exit, had to determine which companies in the portfolio to continue to fund.

Investors who are willing to risk additional capital, want all of the other investors in for the ride as well and 'pay-to-play' provisions are designed to encourage continued participation based on the 'stick' not the carrot. Even though markets appear to be stronger, pay-to-play in the US is: (i) increasing; and (ii) include more 'convert to common' results.

(ii) *What the investors get to avoid*: Without pay-to-play, so the theory goes, those who do not play and who continue to hold a preferential security, get to go along for the ride and get the benefit without the burden. There is a built-in motivator to avoid the awkward situation of a member of the 'syndicate' breaking ranks from a pro rata inside follow-on.

(iii) *How they are structured*.

A. Lose future rights to participate (see above)

B. Get a 'lesser' grade of preferreds (create preferreds in series to accommodate this)

C. Convert to common, and lose all of the preferential rights on original investment.

WatchMark Corp v. ARGO Global Capital, LLC (Delaware Chancery Court, November, 2004). WatchMark is a wireless networking software company based in Bellevue, Washington. WatchMark wanted to acquire Metrica Service Assurance Software Group. WatchMark's board of six had 5 VC nominees, one of which was a nominee of ARGO. The board approved the merger in 2004. At the same time as the merger negotiations were going on, the board was also negotiating the issuance of a new series of preferred shares to finance the acquisition. All of the investors were invited to participate. A number of investors had agreed to the terms of the financing including the conversion of outstanding preferred shares of non-participants, to common stock. ARGO informed WatchMark that it would not participate in the financing.

The WatchMark charter provided protective provisions requiring consent of each series of preferred stock to any 'adverse charter amendment' as well as a 'no-impairment' clause. But, it did not contain words "whether by merger, consolidation or otherwise" which have been determined as necessary in order to clarify that adverse changes to preferred stock are intended to be blocked not only where the issuer's charter is amended, but also if there are adverse changes effected through a merger.[9] As those words were not in the charter, WatchMark formed a wholly-owned subsidiary, merged with it and successfully eliminated ARGO's ability to block the financing transaction.

ARGO then argued that the board breached its fiduciary duties by approving transactions that would result in the forced conversion of ARGO's preferred stock into common stock. The court, however, concluded that, because all preferred shareholders were treated the same way with respect to 'pay-to-play', the board had not breached its fiduciary duties. In particular, all series of preferred shares lost their protective rights, not just the series held by ARGO. Also all preferred shareholders including ARGO could have participated in the financing and therefore it was only a preferred shareholder's decision not to participate that 'caused' the conversion to common stock (ie the preferred shareholder shot itself in the foot). As a final comment, ARGO had indicated a willingness to participate, but only if the deal terms were sweetened.

Hints – allow all preferred shareholders to participate in pay-to-play and, if possible, have all preferred shareholders participate in negotiating its terms. Make sure protective provisions are comprehensive. The new provisions should only affect a party's pre-existing investment to the extent of that party's non-participation in the next round.

Dissenters rights? Section 238 *Business Corporations Act* (BC) and section 244, a dissenting shareholder may require the company to repurchase its shares.

(b) Retraction Rights. In addition to the terms outlined above for redemption rights (see paragraph 3(a)(ii)), investors may want retraction rights (likely will end up with redeemable on the same time-frame (eg. retractable after 5 years, if redeemable after 5 years, if can redeem a portion, can retract a portion). Consider timing of repayment (e.g. quarterly over two year period, or annually over 4 year period etc.). If payment over time, does the investor also secure against the assets of the company as a creditor entitled to collect the indebtedness of the company to the investor for repurchase of the shares? Are there other 'note-holder' types of provisions and covenants that the investor gets while waiting to get paid out in full. Note that retraction rights after a particular period will result in the preferred shares being classified as a debt instrument (see comment at 2(a)).

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[9] The NVCA Term Sheet as commented on by the ABA raises at Footnote 8 the case of Benchmark Capital Partners IV LP v. Vague (2002) and Elliott Associates, LP v. Avatex Corp. (1998) which confirmed this point.

Exhibit 1

TERM SHEET

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].[10]

[10] 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 not common and may invite later disputes

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				

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concerning milestone achievements and will likely 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 are met but other events adverse to the Company occur (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 make subsequent milestone payments by _________, 20__, or] (iii) terminate the Commitment without any further obligation or liability on the part of the Investors.]"

[Common – Warrants]

Series A Preferred

Total

CHARTER[11]

Dividends:	[*Alternative 1*: A non-cumulative dividend on the Series A Preferred Stock at the rate of [__]% per annum will be payable only when and if declared by the Board and prior to any dividends to any other class.[12]] [*Alternative 2:* The Series A Preferred Stock will carry an annual [__]% cumulative dividend [compounded annually], payable upon a liquidation or redemption. For any other dividends or distributions declared by the Board, the Series A Preferred Stock will participate with the Common Stock on an as-converted basis.]

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11 The Charter is a public document, filed with the [Delaware] Secretary of State, 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.

12 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.

13 Generally, cumulative dividends are very unusual. In some cases, accrued and unpaid dividends are payable on conversion as well as upon a liquidation event. Most typically, however, dividends are not paid if the preferred is converted. Another alternative is to give the Company the option to pay accrued and unpaid dividends in cash or in common shares valued at fair market value. The latter are referred to as “PIK” (payment-in-kind) dividends.

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[*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]

Liquidation Preference: In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:[14]

[*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.]

[*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.]

[*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

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[14] While preferences are set up to pre-negotiate returns to shareholders in the event of an acquisition of the Company, under California law (which may apply to Delaware companies under the Section 2115 long-arm statute, please see note at the end of this footnote) 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 common shareholder, 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.

Original Purchase Price (including the amount paid pursuant to the preceding sentence).]

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

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) the Series A Preferred Stock as a class shall be entitled to elect [_______] [(_)] members of the Board (the "**Series A Directors**"), (ii) as provided under "Protective Provisions" below or (iii) as required by law.[15]

Protective Provisions: So long as [*insert fixed number, or %, or "any"*] shares of Series A Preferred Stock are outstanding, the Company will not, without the written consent of the holders of at least [__]%[16] of the

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[15] 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 5 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."]

[16] As with all percentage vote thresholds, consideration will need to be given to whether any single investor 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 this to be high enough so that a significant portion of the investor base is behind the demand 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. Especially in subsequent rounds of financing, the determination of whether all series of preferred 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 statute (see footnote 8).

Company's Series A Preferred Stock, either directly or by amendment, merger[17], 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 Stock];[18] (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;] or (b) 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_, as amended][19]; (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

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17 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 if such changes or effects result from a merger unless the charter expressly provides as such.

18 Note that as a matter of background law, 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 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.

19 For California corporations, one cannot reference to a contractual agreement outside the Articles of Incorporation.

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

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; (vii) authorize any action that results in the transfer of material assets of the Company to any person other than a wholly-owned subsidiary of the Company; [(viii) appoints a new chief executive officer], or [(x) changes the Company's accounting practices or auditors].[20]

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 described below under "Anti-dilution Provisions."

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:

[*Alternative 1:* "Typical" broad-based weighted average:[21]

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

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

[21] The broad-based weighted average formula 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 the rarely used narrow-based formula which only includes common stock issuable upon conversion of a particular series of shares of Preferred Stock outstanding which is more favorable to investors.

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 the price at which the new shares are issued.][22]

[*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

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22 The full ratchet provision is quite draconian to the Company's existing shareholders 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). From a Company standpoint if such a 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 to not trigger adjustments in stock issuances that are not related to equity financing activities.

23 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 which 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.

Company's Board of Directors [including at least [_______] Series A Director(s)[23]]; [(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 financial nature; (vii) securities issued pursuant to an acquisition of another corporation by the Company; or (viii) securities that are otherwise excluded by vote or written consent of holders of a [__]%[24] of Series A Preferred Stock.]

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 [___] 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 Stock.[25]
[Pay-to-Play:	[Unless the holders of [__]% of the Series A elect otherwise,] on any subsequent down round all [Major][26] Investors are required to participate to the full extent of their participation rights (as described 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])]. All

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24 The percentage in this section usually matches the percentage in the Protective Provisions section.

25 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.

26 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.

shares of Series A Preferred Stock[27] 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].[28]

Redemption Rights:[29]	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)].[30]

STOCK PURCHASE AGREEMENT

27 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).

28 If the punishment for failure to participate is losing some but not all rights of the Preferred (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 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.

29 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 used; 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.

30 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.

Representations and Warranties:	Standard representations and warranties by the Company.[31]
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 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**."[32]
Demand Registration:	Upon earliest of (i) [4-6] 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

31 Note that while it is not at all uncommon in East Coast deals to require the Founders to personally rep and warrant (at least as to certain key matters, and usually only in the Series A round), such Founders reps are rarely found in West Coast deals.

32 Note that Founders/management sometimes also seek registration rights.

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).

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.
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 $[______] of Series A Preferred.

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.

[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.

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.][33]

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

Right to Participate Pro Rata in Future Rounds:

All [Major] 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 and warrants), to participate in 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). [In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors

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

shall have the right to purchase the remaining pro rata shares.]

Matters Requiring Investor Director Approval:[34]

[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];[35] (vii) hire, fire, or change the compensation of the executive officers, including

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[34] These covenants are unusual and often superfluous because the investor director(s) generally control the Board anyway.

[35] Note that Section 402 of the Sarbanes-Oxley Act of 2003 would require repayment of any loans in full prior to the Company filing a registration statement for an IPO.

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.]

Non-Competition and Non-Solicitation Agreements:[36]	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.
Board Matters:	Each Board Committee shall include at least one Series A Director. [The Board of Directors shall meet at least [monthly][quarterly], unless otherwise agreed by a vote of the majority of Directors.] The Company will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors. 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 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].

[36] 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.

	[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:[37]	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/ Right of Co-Sale (Take-me-Along):	Company first and Investors second [(to the extent assigned by the Board of Directors,)] have a right of first refusal with respect to any 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)], [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

[37] 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 impact the IPO. Hence, such an alternative is not provided for here.

securities held by the seller and those held by the participating Investors. These rights of first refusal and co-sale shall be subject to certain standard exceptions.[38]

Board of Directors/Voting Agreement:	Immediately after the Closing, the Board shall consist of [______] members. The Series A Preferred Stock shall have the right to elect [____] director(s) with [_____] having the right to designate [____] director(s), who initially shall be [_________]. The holders of the Common Stock shall be entitled to elect [_____] director(s), one of which shall be the Chief Executive Officer of the Company, who initially shall be [______________]. The Series A Preferred Stock and Common Stock, voting as one class, shall be entitled to elect [_________] director(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].[39] The directors shall be entitled to reimbursement of reasonable costs of attendance at meetings of the Board.
[*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 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] [and the holders of a [majority][super majority] of the outstanding shares of Preferred Stock, on an as-converted basis].

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38 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.

39 Holders of Common Stock may 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].

[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.]
Termination:	All rights under the Right of First Refusal/Co-Sale and Voting Agreements shall terminate upon an IPO or a Deemed Liquidation Event.

OTHER MATTERS

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*[40]*:*	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 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

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

	liquidated damages.][41] 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][42]

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41 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).

42 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.

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