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PREPARING A VENTURE CAPITAL TERM SHEET

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I. Purpose of the Term Sheet.

The "term sheet" or "letter of intent" is a key document in a venture capital transaction. Whether the initial agreement as to terms is structured as a "term sheet" or a "letter of intent" is a technical difference, and the choice of designation is largely one of personal preference with no substantive effect. For simplicity, this article uses the phrase "Term Sheet" to describe the initial agreement as to the terms of a transaction.

By focusing on the Term Sheet, the attention of the company seeking the investment (the "Company") and the venture capital investor (the "Investor") is directed to the major business and structural issues involved in the proposed investment. The parties relatively quickly may either reach agreement on major terms or come to the realization that the investment will not be feasible because of irreconcilable differences on fundamental issues. In either case, drafting time and expense are saved.

The material terms included in the Term Sheet can be divided into three categories: (1) terms that impact valuation and economic division of profits and proceeds upon a liquidity event, (2) terms that impact control over decision making, and (3) reasonable market investor protection terms.

The process of preparing and negotiating a Term Sheet helps to solidify the transaction and to create a sense of momentum between the parties. A well drawn and complete Term Sheet will facilitate the drafting of the final documents, and therefore will help to minimize the time and effort required to draft and negotiate the final agreements. In addition, an executed Term Sheet may assist the Company in its negotiations with strategic allowance partners, creditors, suppliers, customers and others.

Each business will have unique issues, and the Term Sheet should focus on those unique issues. Generally, with respect to internet, software and other information technology companies, deal breaking issues most often arise in the areas of intellectual property and employment matters. These issues should be addressed early in the transaction process, and the understanding of the parties should be reflected in the Term Sheet.

A form of Term Sheet, attached to this article as Appendix A, is based on a form developed by the National Venture Capital Association (the "NVCA"). The attached form of Term Sheet reflects a conventional Series A preferred stock investment incorporating many of the terms discussed in this article, and includes alternatives frequently considered by Investors.

II. Ensuring that the Term Sheet is Non-Binding.

Merely because the document that the parties have executed is characterized as a Term Sheet does not mean that the document could never operate to create a legally binding contract. Therefore, the Term Sheet should specifically provide that it is not, in

and of itself, binding upon either the Company or the Investor. Rather, all obligations must be made contingent upon the negotiation and execution of the final agreements, and the prior satisfactory completion by the Investor of additional due diligence. Otherwise, the Investor may find itself forced, pursuant to the Term Sheet, to make an investment that subsequent investigation or events demonstrate was not in its best interests.

In addition, parties should give consideration to the choice of which jurisdiction's law will govern the Term Sheet. In certain states, such as Delaware and New York, a term sheet can create an enforceable obligation on the parties to negotiate the terms set forth in the Term Sheet in good faith, even if the Term Sheet expressly states that it is nonbinding.

One significant exception to the non-binding nature of a Term Sheet often arises with regard to expenses. Term Sheets frequently provide that, although the main provisions are non-binding, certain expenses of the Investor are to be borne by the Company, even if the transaction is never consummated. If this is the intention of the parties, the Term Sheet should specifically state that the parties are legally bound by such a provision. If the parties have not entered into a separate confidentiality agreement, the Term Sheet may contain binding provisions regarding maintaining confidentiality of information supplied by the Company and possibly the negotiation of the transaction itself.

An Investor sometimes will require Companies to agree to an exclusive negotiation period, sometimes referred to as a "no-shop" period. Given that the Investor may have expended significant time and effort in conducting due diligence and negotiating deal terms, an Investor will not want the Company to use the Term Sheet to leverage better deal terms from other Investors. Companies, however, should exercise caution in agreeing to a no-shop. Agreeing to a no-shop too early in the process may foreclose better opportunities. In addition, a no-shop can be increasingly coercive when the Company is close to running out of money. Ultimately, from the Company's perspective, a no shop is problematic because Investors do not have an obligation to proceed with the investment. With no guarantee of a deal, the Company may be left with no options or bad options at the end of the no-shop period. Whether the Company should ultimately agree to a no-shop period will depend on a number of factors, including, among others, the Company's financial condition, the negotiating leverage of the parties and market conditions.

Despite the non-binding and summary nature of the Term Sheet, it is not uncommon for the Company, upon receipt of the first draft of the definitive agreements, to exclaim, "but this wasn't in the Term Sheet!" Accordingly, it is important to include all key provisions in the Term Sheet, while, explicitly conveying the message to the Company that the Term Sheet will not contain every provision of the transaction as finally documented.

III. Terms that Impact Economics.

A. Type of Securities.

The Term Sheet will indicate the type of securities that the Investor contemplates purchasing, whether common stock, preferred stock, warrants, debt securities, partnership interests, membership interests, another type of security, or some combination of the foregoing. If debt securities are involved, the Term Sheet should state whether the debt is to be subordinate to debt from banks, financial institutions, trade creditors, or other third parties. If common stock is to be purchased directly, or upon the conversion of other securities, the Term Sheet should indicate whether the common stock is to be of the same class or series as existing shares of common stock, or a new class or series with different voting rights. If preferred stock is involved, the Term Sheet should indicate the rights, preferences, restrictions, conversion rights, voting rights and other special or relative rights of such preferred stock, many of which are described in greater detail below. The basic rights of each class of stock will be set forth in a Company's Articles or Certificate of Incorporation, generally known as a "charter."

This article assumes the Company is a corporate entity. However, increasingly, a limited liability company entity is preferred because this form of entity: (1) is taxed as a partnership for federal income tax purposes; (2) provides limited liability to its members; and (3) unlike an "S" corporation, may have owners who are not individuals. Although often tax efficient, a limited liability company investment can be an administrative nightmare for venture investors structured as limited partnerships or other flow-through entities, because they must include the Company's K-1 information on their K-1. A careful analysis should be made early on as to what the optimal entity structure for the Company would be after the Investment. If a non-corporate entity is chosen, the Term Sheet should include a clause providing for conversion to corporate form, and the mechanics therefor, prior to an initial public offering. Generally, the issues relating to investment are similar, regardless of the entity chosen.

B. Amount of Investment and Capitalization.

The Term Sheet should set forth the total dollar amount all Investors are prepared to invest in the Company in this round of financing (the "Investment"), as well as the percentage of the Company the Investors will own, on a post-closing, fully-diluted basis, after all convertible securities, options, warrants and other rights have been converted or exercised after the calculation of all anti-dilution adjustments that may be triggered as a result of the transaction. The parties should modify this provision to account for staged investments or investments dependent on the achievement of milestones by the Company. The Term Sheet should also specify whether outstanding bridge notes are being converted in the financing. A current and projected post-closing ("pro forma") capitalization table is usually set forth as an exhibit to the Term Sheet.

C. Price Per Share.

The price per share is the pre-money valuation of the Company divided by the number of shares outstanding prior to the Investment. The pre-money valuation is the valuation of the Company prior to the Investment. The number of shares outstanding or "fully-diluted" number is often a subject of negotiation. The term "fully-diluted" generally includes all outstanding common stock, preferred stock (on an as-converted basis), options, warrants and other convertible securities as if fully exercised or converted. One heavily negotiated issue is whether "outstanding options" includes only issued options, or unissued options as well. If it is to include unissued options, the parties must further decide whether this includes the additional unissued options resulting from any increase in the option pool as a result of the financing. For a more in-depth discussion regarding the stock option pool increase and negotiations with respect thereto, see Section J below.

The general rule is that the larger the basis (the agreed upon number of outstanding shares), the less the Investors will have to pay per share of stock in connection with the Investment, and the greater the dilution to the existing stockholders. This is a function of the formula: per share price = pre-money valuation / total outstanding shares prior to Investment. The principle behind the negotiation of the definition of "fully-diluted basis" is deciding who will bear the cost of dilution. If the number of the securities in question are included in the fully-diluted number, the existing common stockholders will assume all of the diluting effect of those securities. If those securities are not included in the fully-diluted number, the existing common stockholders and the new Investors will assume on a pro rata basis the diluting effect of those securities. The Investors will argue for a larger fully-diluted basis (i.e., one including the unissued options) so that the existing stockholders will assume the diluting effect when those options are issued and exercised. The Company will argue for a sharing of the diluting effect of the unissued options equally between the existing common stockholders and the new Investors, since the options provide an incentive from which all stockholders will benefit.

D. Dividends.

If the Investment is intended to yield a current return, customarily in the form of a dividend, the amount of this return should be clearly specified. Dividends may be cumulative or non-cumulative. A cumulative dividend is a dividend that accrues regardless of what the Company does. A noncumulative dividend only will accrue, and be payable, if the Company declares the dividend. Noncumulative dividends are more Company favorable than cumulative dividends.

Even with cumulative dividends, venture investors typically do not anticipate actual dividend payments. Rather, cumulative dividends are viewed as a means to boost the underlying equity investment. Upon conversion of the preferred stock, the cumulative dividends convert into additional common stock, which increase the Investor's percentage ownership interest in the Company. Cumulative dividends will also typically be paid upon payment of the liquidation preference and any redemption.

Companies should be particularly wary of cumulative dividends that compound given the potentially significant effect on total returns. In addition, Companies should be cognizant of the fact that accumulating dividends are liabilities that generally appear on the Company's balance sheet, which may impair the Company's ability to borrow.

To provide some flexibility in the event cumulative dividends pose an impediment to an important prospective transaction, the parties should agree to some method by which the board of directors or the preferred holders may waive cumulative dividends. In some cases, accrued and unpaid dividends are payable upon conversion, as well as upon a liquidation event. 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.

E. Rights Upon Liquidation.

The Term Sheet should indicate whether the Investor has a preference upon liquidation. These "liquidation preferences" typically apply to distributions in connection with a merger, consolidation, or a disposition of substantially all of the assets of the Company through either a sale, exclusive license, or lease. If the venture proves to be unsuccessful, the Investor who provided the most recent funds to the Company often will get first opportunity to recover its Investment. Typically, an Investor who has purchased shares of preferred stock will be entitled to receive, upon liquidation, an amount equal to its Investment, or some multiple thereof, prior to distribution of proceeds to the holders of securities which rank junior to such series of preferred stock, for purposes of liquidation. The Term Sheet should specify such entitlement and whether the holders of preferred stock will be entitled to participate in the distribution of additional proceeds among holders of common stock, on an as-converted basis ("participating preferred") or if the Investor must convert to participate in proceeds distributed to holders of common stock ("straight preferred" or "non-participating preferred").

With "non-participating" preferred stock, upon a sale or liquidation of the Company, the preferred holders are entitled to receive only the amount of their preference (typically the amount paid for the stock), plus any accrued and unpaid dividends. Any remaining proceeds are distributed exclusively to the common holders. If the common holders would receive more per share than the preferred holders upon a sale or liquidation, the preferred holders can convert their shares into common stock immediately prior to the sale or liquidation and give up their preference in exchange for the right to share pro rata in the full liquidation proceeds. Management and other common holders generally favor non-participating preferred stock because it requires that the preferred holders to convert and stand on equal footing with the common holders to receive a gain on their Investment beyond the negotiated preference amount.

With "participating" preferred stock, preferred holders are entitled to receive their preference amount first in a liquidation event, plus any accrued and unpaid dividends, and then any remaining proceeds are divided among holders of common stock and

preferred stock on an as-converted basis. Participating preferred stock provides a significant benefit to the Investors, at the expense of the founders, whose right to any residual amount after payment of the preference is cut by Investors' participation in the distribution of the remaining amounts. A participation feature may be more justified when the risk associated with the Investment, or in a later stage Investment, the possibility of a sale shortly after the Investment, justify a premium. One alternative is to provide the Investors with a participation feature, but cap the amount of participation at some multiple of the purchase price. This alternative can be used in situations when the risk of investment in the business, or closeness of a sale, justify it, but do not justify the Investors getting the benefit of the participation feature in a true "home run" exit. If the capital return is exceeded, the Investor would convert to common stock to receive the full upside if the exit was sufficiently lucrative.

Despite the common use of this feature, it is a term of great contention, as it is the one feature that can have the greatest impact on the exit returns of everyone from the founders to the preferred stock investors. Founders sometimes focus on initial public offering ("IPO") scenarios, in which liquidation preferences typically do not come into play, without due regard for other, more likely liquidation scenarios, when Investors will have a preference. Investors should exercise discretion when negotiating liquidation preferences. Liquidation preferences, particularly those that provide for multiple returns or participation rights, may result in skewing management incentives toward an IPO when an acquisition may be a more realistic or strategically desirable outcome. Therefore, all parties to a preferred stock financing must pay particular attention to the size and participation of the liquidation rights.

F. Redemption or Repurchase Rights.

Redemption rights allow Investors to force the Company to redeem their shares, generally at cost plus any accrued or unpaid dividends. Some redemption features are at fair market value on the date of the redemption election. In practice, redemption rights are not often used, however, they do provide a form of leverage over the Company to facilitate an exit transaction after a reasonable investment period. While it is possible that the right to receive dividends on redemption could give rise to an IRS Code Section 305 "deemed dividend" issue, 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, then there is no Section 305 issue.

If the securities are subject to redemption or repurchase at some point in the future, the Term Sheet should outline the circumstances under which such a redemption or repurchase may occur. For instance, the Term Sheet should indicate: (1) whether the redemption or repurchase is to be optional (and at whose option) or mandatory; (2) when the obligation to redeem or repurchase will arise (i.e., on the death of a principal in the Company, a public offering, or a particular date); (3) whether the redemption or repurchase obligation applies to only unconverted or unexercised securities, or also to the shares of common stock received upon such conversion or exercise; (4) the price, or method of computing the price, at which the redemption or repurchase will occur; and

(5) the consequences for the failure to redeem (i.e., the ability to elect additional directors and control the board).

G. Reimbursement of Investor Expenses.

Investors often will require reimbursement for the legal, diligence and administrative costs of the financing, up to a predetermined cap. The Term Sheet should specify whether the Company will reimburse the Investors for out-of-pocket diligence and administrative fees, and for the expenses of Investor's counsel, the cap on expenses, and whether such expenses are reimbursable only upon the successful closing of the Investment, or regardless of whether the Investment closes.

H. Vesting of Founder Shares.

Term Sheets sometimes include a discussion of the Investors' expectations regarding the vesting of founders' shares. Vesting of founders' shares can be a contentious issue, particularly if the founders' shares are not presently subject to vesting, or are subject to a different vesting schedule than contemplated by the Investors.

Investors will want founders' shares to be subject to vesting, even when shares have been purchased for value or have previously vested, to create an incentive for the founders to remain committed to the Company, particularly when a significant portion of the value of the enterprise lies in the "human capital" of the founders. Vesting also helps to mitigate the potential dilutive effect associated with filling a management position vacated by a departing founder (i.e., any unvested shares may be allocated to the new hire).

Founders may object to vesting requirements, particularly with respect to stock purchased for value or when vesting does not appropriately account for the time and effort already contributed by the founder. The Term Sheet should set forth any conditions regarding founder share vesting or "re-vesting." In addition, the Term Sheet may provide that the Company will have the right, upon termination of services, to repurchase any unvested shares.

I. Employee Stock Options.

Term Sheets often include vesting provisions applicable to employee stock options, as Investors want to ensure that key employees remain committed to the Company. When key employees are hired, they often are given shares or options to buy shares of the Company as part of their compensation. If such options are promised, they usually are earned over time. Step vesting often occurs in annual, quarterly, or monthly increments, usually over periods of two to four years. Cliff vesting occurs all at one time. It is common to see cliff vesting of a percentage of the shares or options after one year, with monthly step vesting for the remainder of the vesting term. The Term Sheet should set forth vesting provisions applicable to employee stock options or restricted stock.

J. Stock Option Pool Increase.

The Term Sheet should set forth the size of the equity plan pool immediately prior to the closing of the financing. The size of the equity plan reserve is often a point of negotiation in a financing. Investors typically insist that an equity plan be put in place in order to attract and retain employees. This pool of shares often is factored into the pre-investment capitalization when arriving at the price per share of preferred stock to be paid by the Investors. When calculated this way, Investors are not diluted by grants under the plan, only the pre-existing stockholders and the founders are diluted.

While the size of the equity pool is important, it can vary significantly from one transaction to the next. The more complete the Company's management team is at the time of funding, arguably, the lower the pool needs to be to attract and retain key hires. Investors generally take the position that there should be sufficient equity in reserve to cover the Company's hiring plan up to the time of the next round of institutional financing.

IV. Terms that Impact Control Rights for Investors.

A. Stock Voting Rights.

The nature of the Investor's voting rights should be indicated in the Term Sheet. The Investor commonly receives the number of votes equal to the number of shares of common stock into which its securities may convert at such point in time, including conversion of dividends, if applicable. The Term Sheet should describe whether the preferred stock purchased by the Investor has "class" or "protective" voting rights (i.e., the holders of preferred stock, or certain classes of preferred stock, voting separately from the holders of common stock must approve certain fundamental transactions), or whether the Investor has special rights to take control of the Company upon the occurrence of certain events of default. However, there are certain transactions in which the preferred and common stock holders vote together as a single class, such as increasing or decreasing the Company's number of authorized shares.

The Investor often will have the right to elect one or more members of the Board of Directors of the Company. The Term Sheet should set forth the means for effectuating these provisions. The preferred method is a required amendment to the Company's charter that provides for election (or appointment by the Company's stockholders) to the Board of Directors of a representative of the class of securities being purchased by the Investor. Such an amendment should be filed prior to, or contemporaneously with, the execution and consummation of the final agreements. If this method is either unavailable because of state law, or impractical because of the particular transaction, then a majority or preferably all of the existing stockholders of the Company should execute a stockholders' agreement, either as a part of the purchase agreement or as a separate document, wherein they agree to vote their shares to elect a member of the Board of Directors appointed by the Investor.

B. Investor Protective Provisions.

Investors often will request special approval rights with respect to certain matters of particular significance to their Investment, in addition to class or series voting rights that may exist under relevant state corporate laws. These special class voting rights are generally referred to as "protective provisions." The nature and extent of the Investor's protective provisions should be indicated in the Term Sheet.

The Term Sheet should set forth any other significant or unusual covenants, both affirmative and negative, that are required to be met by the Company, such as an amendment to the Company's charter or bylaws limiting director liability, to the extent available. The Term Sheet should refer to appropriate negative covenants, such as: (1) the Company not merging, selling its assets, or otherwise implementing any fundamental changes in its business; (2) not amending its charter or bylaws without Investor approval; (3) not creating or issuing any additional shares of capital stock each without the approval of the Investor; or (4) not holding capital stock in any subsidiary unless it is a wholly-owned subsidiary of the Company. In addition, the Term Sheet should provide that other "standard and customary covenants" will be included in the final agreements. It is worth noting that under Delaware law, 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 as a matter of law.

Protective provisions can serve an important role in protecting the interests of the Investors, particularly when the Investors have a minority position in the Company, and there are a number of fairly standard protective provisions. It is in the interests of all parties, however, to exercise caution with respect to protective provisions. Care should be exercised to ensure that each protective provision is reasonable and appropriate in light of the expected benefit to the Investors and the administrative burden on the Company associated with having to regularly obtain stockholder approval. Protective provisions, particularly those with high vote thresholds, have the potential to expose the Company and the Investors to opportunistic behavior by other Investors. In addition, unnecessarily strict or vague restrictions may result in an inadvertent violation of the Company's charter, which can have a number of negative consequences.

It is prudent to provide that the protective provisions will terminate if the number of outstanding shares of preferred stock falls below a de minimus amount. In the unlikely event that a small number of preferred remain outstanding, the Company and the other Investors, including any preferred holders that have converted to common, will want to avoid a situation where the remaining preferred stockholders are able to exercise influence disproportionate to their holdings. The threshold should be determined based on the capitalization of the Company.

C. Board Representation.

Stockholders, typically the preferred holders and the major common holders, often will enter into a voting agreement to allocate board seats to particular groups of stockholders. Even if the Company's charter provides for class voting for directors, a voting agreement can specify how seats within a particular class will be allocated among holders of that class. For example, if a particular class has the ability to elect two directors, a voting agreement can further specify which stockholders in the class have the right to designate one of the directors and which stockholders have the right to designate the other. Use of voting agreements may help venture capital funds qualify for the venture capital operating company exception under the plan asset regulations of the Employment Retirement Income Securities Act of 1974 ("ERISA"). The voting agreement generally will terminate upon an IPO of the Company.

D. Matters Requiring Investor Director Approval.

The Term Sheet may set forth corporate activities that require approval by the director appointed by the Investors, such as: (1) changing the principal business of the company; (2) owning stock in another corporation unless it is wholly-owned by the Company; (3) selling material technology or intellectual property, other than the licenses granted in the ordinary course of business; or (4) changing the compensation of the executive officers. This category of investor rights attempts to give minority Investors protection against a laundry list of possible expropriation by managers and other Investors. The danger of a long list of matters requiring Investor director approval is that the Company may be hamstrung in its ability to operate its business. Investors must walk a fine line between protecting their Investment and encouraging corporate growth.

E. Non-Compete and Non-Solicitation Agreements.

Investors often request that employees of the Company execute Non-Compete and Non-Solicitation Agreements in order to protect their Investment in the Company. 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. Some Investors do not require such agreements because they fear that employees will request additional consideration in exchange for signing a Non-Compete and Non-Solicitation Agreement. Indeed the agreement may arguably be invalid absent such additional consideration, although having an employee sign a non-compete contemporaneously with hiring constitutes adequate consideration. Others take the view that it should be up to the Company's Board of Directors on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Non-Competes often have a one year duration, although state law may permit two years or more. The Term Sheet should specify whether and which employees are required to execute Non-Compete and Non-Solicitation Agreements.

V. Reasonable Market Investor Protections.

A. Anti-Dilution Provisions.

If the Investor is purchasing securities that are convertible into or exercisable for shares of common stock, the Term Sheet should set forth the circumstances of conversion (i.e., optional or mandatory conversion), and the conversion ratio (i.e., one-for-one, one-for-two) upon which the conversion is to be based. Because common shares typically receive the residual amount in connection with any liquidation, after payment of any liquidation preference to the preferred, the ability of preferred shares to convert into common shares enables the preferred shares to participate in any upside in the event the liquidation amount exceeds the liquidation preference.

In most venture financings, each share of preferred stock is convertible into one share of common stock, subject to anti-dilution adjustments, as discussed later in this article. In rare cases, the conversion ratio may be adjusted from something other than one-for-one, in lieu of cumulative dividends or other guaranteed minimum returns.

Investors typically request protection against possible dilution in their holdings that may occur as a result of additional issuances of securities or other changes to the Company's capital structure. At a minimum, anti-dilution protections provide adjustments for mechanical changes resulting from stock splits and similar recapitalizations that do not affect the underlying economics. Provision for mechanical adjustments is generally not controversial and will normally be included in financing documents.

In addition to mechanical adjustments, major Investors typically request that the Company's charter provide for adjustments to account for the dilutive effect of future stock issuances at a lower purchase price than paid by the Investor. These price-based anti-dilution adjustment mechanisms typically effect some change to the conversion ratio of the preferred stock. In general, price-based adjustment mechanisms are divided into "weighted-average" formulas, "full ratchet" adjustments, or some combination of the two. Weighted-average formulas are the most common. Weighted-average formulas account for the number of shares issued in the new financing and the number of shares already outstanding (in addition to the respective prices at which the shares were issued) in adjusting the conversion price. Full-ratchet formulas adjust the conversion ratio of the preferred to reflect the new lower price at which the new securities are issued, without accounting for the number of shares to be issued or previously outstanding. Because it does not calibrate for differences in the size of a new issuance relative to previously outstanding shares, a full-ratchet formula tends to result in more dramatic changes than weighted-average formulas.

Note that exclusions to anti-dilution are frequently negotiated and included in preferred stock financings. Such exclusions can include: (1) securities issuable upon conversion of any of the Series A Preferred; (2) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (3) common stock issuable upon a stock split, stock dividend, or any subdivision of shares of common stock; or (4)

issuances in connection with equipment leasing, real property leasing, or commercial borrowing.

Investors, however, sometimes may request additional protections to help ensure that their interests are protected. An efficient way to accomplish this is to require, in addition to board approval, approval by a director appointed by the Investors. Care should be exercised with respect to requiring unanimous board approval when other options are available. Requiring approval of a director appointed by the preferred may sufficiently safeguard the Investors' interests while avoiding some of the "hold up" risk associated with a unanimous approval requirement. Under a unanimous approval requirement, any single director can effectively hold up a transaction that might otherwise be considered by all of the other directors to be in the Company's best interest. Another approach is to impose caps on the number of shares that may be issued under the different exceptions. Consider, however, that these caps can be cumbersome to increase in the future, because an increase would require an amendment to the charter, and can expose the Company to the risk of inadvertently triggering an anti-dilution adjustment.

B. Mandatory Conversion.

The Term Sheet should specify the circumstances under which the Investor must convert all shares of the Company's preferred stock held by the Investor into shares of the Company's common stock. It is typical in preferred stock financings to include provisions for "automatic" conversion of all of the preferred stock into common stock upon the vote or written consent of holders of a defined minimum number of shares. This helps to avoid the risk of holdouts when the conversion, or a transaction contingent upon the conversion, is in the best interests of the Company and the stockholders as a whole. It is typical to provide for automatic conversion in connection with an IPO that meets specified criteria as to size and valuation. For example, the term sheet may specify that each share of preferred stock will automatically be converted into common stock in the event Underwriters for the IPO will want the Company's capitalization structure to be simplified to the extent possible to facilitate the underwriters' marketing efforts.

Automatic conversion by stockholder vote provides a convenient means to simplify the Company's capitalization structure, without having to undertake to amend the charter or to get the unanimous agreement of the preferred holders to convert their shares. Automatic conversion may, for example, reduce the risk that a minority of stockholders, or the holders of a particular series, will effectively have the ability to block important transactions that may be contingent upon a more simplified capital structure (i.e., a highly-dilutive financing or an IPO that does not meet separate automatic conversion thresholds).

A new Investor in a later-stage financing should exercise care in negotiating the automatic conversion provisions, particularly if the new Investor is entitled to a larger preference or has priority relative to other series. The new Investor should be cognizant of the risk that the other Investors may be able to effectively eliminate any preferences

or priority by effecting an automatic conversion through a class vote of all of the preferred voting as a whole. To protect its liquidation preference, the new Investor may want to request a higher vote threshold or a separate series vote.

Since the conversion of all preferred stock into common stock may be a practical condition precedent to a public offering of the Company's common stock, the Company will want lower thresholds. In contrast, the Investors will not want to be forced to convert to common stock unless they are assured of a sufficient return on their Investment and will want to ensure that there is sufficient liquidity to allow them to sell their shares. To ensure that the Investors receive an appropriate return on their Investment before an automatic conversion, the per share minimum offering price ensures that the Investor achieves a significant return on Investment before the Company can go public. The price is typically in the range of three to five times the original issue price.

C. Representations and Warranties in the Preferred Stock Purchase Agreement.

It usually is not necessary to set forth in the Term Sheet all of the representations and warranties that will be requested of the Company. It often is desirable, however, to set forth some of the key representations and warranties, especially those that are specific to the particular Company or transaction, in order to give the Company a sense of the scope of the representations and warranties that will be required. To avoid the appearance that these are the only representations and warranties that will be sought, the Term Sheet should provide that other "standard and customary representations and warranties" will be included in the final agreements. The Term Sheet should specify any issues relating to intellectual property of the Company that either the Investor is relying upon in making its investment decision or that will need to be contributed by the founder to the Company, or otherwise resolved prior to closing.

Founders' representations are sometimes requested and may elicit significant resistance as they are found in a minority of venture deals. They are more likely to appear if founders are receiving liquidity from the transaction, or if there is heightened concern over intellectual property (*e.g.*, the Company is a spin-out from an academic institution or the Founder was formerly with another company whose business could be deemed competitive with the Company), or in international deals. Founders' representations are even less common in subsequent rounds, where risk is viewed as significantly diminished and fairly shared by all then existing stockholders, rather than being disproportionately borne by the Founders.

D. Closing Conditions.

The Term Sheet should set forth any conditions required to close the Investment. Customary closing conditions include satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of an amended charter establishing the rights and preferences of the newly authorized series of preferred stock, and an opinion of counsel to the Company.

E. Closing.

The Term Sheet should set forth the anticipated closing date of the financing. The Term Sheet should set forth whether the Company will allow additional Investors to join after the initial closing within a reasonable time period, typically sixty to ninety days. This allows the Company to give Investors flexibility in coming up with capital, and also allows the Company to raise funds from smaller Investors that have not committed prior to the initial closing. Sometimes the parties will agree to stage or "tranche" an Investment in the Company, whereby the Investors will make an initial Investment in the Company and then agree to invest additional amounts upon the Company reaching certain milestones; typically financial targets, patent or regulatory approvals, or the execution of key customer contracts.

F. Use of Proceeds.

The Investor may desire to set forth in the Term Sheet the use of the Investment proceeds by the Company, while also identifying certain matters to which the proceeds cannot go towards. For example, the parties may agree that the Company will use the proceeds for product development, with the condition that the Company will not use the proceeds to repay certain debt obligations or to pay out bonuses.

G. Registration Rights.

It is important for Investors to have a means to eventually liquidate their Investments. Securities sold in private financings typically are subject to restrictions on resale under securities laws. Although there are certain exemptions from these resale restrictions, these exemptions subject the Investors to holding periods and other potentially applicable conditions that may limit the ability of Investors to resell their shares.

The Term Sheet should indicate whether the Investor is to receive registration rights for public offerings of the shares purchased. If the Investor does receive registration rights, then the Term Sheet should indicate: (1) when, during what period, and how frequently the Investor may demand registration of its shares; (2) whether the Investor receives "piggyback","S-3", or "demand registration rights"; and (3) who pays the expenses of each such registration.

Although it is somewhat unusual for registration rights to be exercised, the availability of registration rights can serve as leverage in affecting the timing of an IPO or other liquidity event, and the extent to which Investors' shares are included in any registered offering. In general, Companies will want to limit the scope of any registration rights due to the time, expense and liability associated with registrations. Note that founders and management sometimes seek registration rights, particularly if registration rights are extended to all shares of capital stock held by the Investors and not just those originating from the preferred stock.

It is typical for Investors to agree to a standard market stand-off agreement, sometimes referred to as a "lock-up", in which the Investors agree not to sell Company

securities for a certain period of time after a public offering. Underwriters for the Company's IPO normally will require that all Company stockholders be subject to market stand-off agreements as a condition to the offering. This helps to ensure an orderly market for the Company's shares following the offering. Because potential disagreements at the time of the offering may delay or threaten the offering, it is ideal for the Company to obtain these lock-up agreements at the time of each securities issuance, rather than wait until the IPO.

H. Management Rights.

The Term Sheet should state whether the Company will grant "management rights" to an Investor. Management rights are contractual rights running directly from the Company to the Investor that give the Investor the right to participate substantially in, or substantially influence the conduct of, the management of the Company. The management rights typically include the ability to attend, advise and consult with management of the Company, attend board meetings and inspect the Company's books and records. Venture funds often request a management rights letter when investing in a Company. Venture funds request these rights in order to obtain an exemption from regulations under the ERISA. Absent an exemption, if a pension plan subject to ERISA is a limited partner in a venture fund, then all of the venture fund's assets are subject to regulations that require the venture fund assets to be held in trust, prohibit certain transactions and place fiduciary duties on fund managers.

A "venture capital operating company" however, is not deemed to hold ERISA plan assets. To qualify as a venture capital operating company, a venture fund must have at least 50% of its assets invested in venture capital investments. In order to qualify as a venture capital investment, the venture fund must receive certain management rights that give the fund the right to participate substantially in, or substantially influence the conduct of, the management of the portfolio company. In addition to obtaining management rights, the fund is required to actually exercise its management rights with respect to one or more of its portfolio companies every year.

I. Information Rights.

Companies will typically agree to provide Investors with periodic financial information and rights to inspect corporate records. These rights provide Investors with important ongoing information concerning their Investment and can also serve to address certain technical legal requirements that can be relevant to venture funds. It is common for Companies to agree to provide quarterly and annual information, as well as an up-to-date capitalization table following the end of each quarter. Before instituting more extensive information requirements, the parties should consider whether the Company is equipped to comply with those requirements in a timely manner and the relative value of that information. The Term Sheet should set forth the extent of the Company's information disclosure requirements.

J. Pre-Emptive Rights.

Investors who own more than a specified number of shares may have preemptive rights, which is the right of the Investor to acquire new securities issued by the Company to the extent necessary to maintain its percentage interest on an as converted basis, these rights should be set forth in the Term Sheet. These rights generally will terminate upon an IPO of the Company. Because pre-emptive rights can add time, expense and complexity to future financing efforts, it is important to ensure that appropriate limitations and exceptions are included in the final documentation.

K. Pay-to-Play.

The Term Sheet may set forth any "pay-to-play" provisions that are applicable to the Investors. In general, a pay-to-play provision requires that Investors participate in the present financing or future financings to retain anti-dilution or other rights. Pay-to-play is a nonstandard provision, and there can be some variation in the scope of the provision (i.e., the particular financings as to which the provisions apply, and the rights affected). Pay-to-play provisions are designed to encourage the participation of existing Investors in a subsequent financing round.

Investors that fail to participate to their full pro-rata percentage of the financing are penalized by losing certain rights with respect to their existing preferred stock. 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 Certificate of Incorporation 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.

Proponents of the provision assert the mechanism benefits both the Company and the Investor by aligning expectations at the outset of the transaction and incentivizing all Investors to continue to support the Company, especially during challenging times when an incentive is most needed. Proponents further contend that absent pay-to-play provisions, those Investors who do not participate in the next financing and who continue to hold a preferential security will receive a "free ride" on the support of the participating Investors. Pay-to-play provisions are designed to eliminate this free-rider dilemma and further ensure that every Investor will pay in one way or another. However, pay-to-play provisions can limit the willingness of smaller funds and individual Investors with limited resources to participate in financings with larger Investors more likely to invoke the pay-to-play provision in the future.

L. Confidentiality and Invention Assignment Agreements.

Investors often request confirmation that employees of the Company execute Confidentiality and Invention Assignment Agreements in order to ensure that the Company owns all intellectual property developed by its employees and that confidential Company information is kept confidential.

M. D&O Insurance.

The Term Sheet should specify if the Company is obligated to maintain Directors and Officers Insurance ("D&O Insurance"). D&O Insurance covers the directors on the Board of Directors and the officers of the Company if they face a lawsuit in conjunction with the duties they are performing for the Company. The amount of insurance purchased will be either a specified minimum amount or an unspecified amount that is satisfactory to the Board of Directors.

N. Key Person Insurance.

The Investor may require the Company to maintain "key person" life insurance on the lives of the top management personnel. In general, this type of insurance is taken out by a business to compensate that business for financial losses that would arise from the death or extended incapacity of an important member of the business, such as one of its founders. The amount of insurance purchased will be either a specified minimum amount or an unspecified amount that is satisfactory to the Board of Directors.

O. Right of Refusal and Co-Sale Rights.

If the Investor is to have a right of first refusal (right of the Investor to be first offered securities to be sold by the founders or other key stockholders) or a right of co-sale (right of the Investor to sell its securities along with any securities sold by the Company or the other stockholders), these rights should be set forth in the Term Sheet. These rights generally will terminate upon an IPO of the Company.

Investors often will require that any founder that intends to sell his or her shares offer those shares first to the Company and the Investors. The primary purpose of the "right of first refusal" is to provide the Company and the Investors with the ability to keep the Company's capital stock within the existing ownership group. If the founders or other major stockholders elect to exit the Company, the Investors will want the ability to purchase their shares so that the Investors may either obtain greater control over the Company, or prevent the transfer of control to non-strategic or hostile parties. Rights of first refusal are typically granted to the Investors and applied against the founders. Occasionally, these rights may also be granted to founders or applied against other major stockholders.

Co-sale rights enable Investors to participate in any sales of the Company's capital stock by founders or other large stockholders. Co-sale rights are principally designed to protect Investors' interests in a situation where founders or others attempt to sell a significant block of common stock. Investors may want the option to participate in the sale since the sale of a controlling interest may involve a control premium and may have the effect of foreclosing other avenues to liquidity. In addition, Investors may generally want an opportunity to liquidate their Investment if the founders are seeking to exit the enterprise. When negotiating co-sale rights, the parties will typically agree to certain exceptions, such as estate planning or *de minimis* transfers.

P. Drag Along Rights.

If the Investor is to have drag-along rights (the right to obligate other stockholders to sell their securities along with securities sold by the Investor), these rights should be set forth in the Term Sheet. These rights generally will terminate upon an IPO of the Company.

A drag-along provision obligates stockholders that are subject to the drag along to vote to approve a transaction that is otherwise approved by a specified percentage of the stockholders. Common holders may sometimes have different interests than preferred holders, particularly when liquidation preferences will have the effect of minimizing the return to the common holders. Drag-along rights provide the Investors with some assurance that the founders and other major common holders who are typically the focus of drag along provisions, and, in some cases, other stockholders, will not attempt to block a sale of the Company through the exercise of class voting rights or otherwise.

The transactions to which drag-along rights apply are those in which the liability of each stockholder is several, rather than joint, and does not exceed the stockholder's pro rata portion of any claim. In addition, the consideration to be paid to the stockholders in such transactions will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Certificate of Incorporation.

The contractual drag-long right is often coupled with proxy so that the designated proxy holder can vote the shares in accordance with the voting agreement in the event the stockholder does not do so.

VI. Other Customary Provisions.

Because the Term Sheet should be designed to be a relatively short document, it will not contain all of the terms and conditions of the transaction. Therefore, it is customary to provide in the Term Sheet that the final agreements will contain "such other customary provisions as may be appropriate." This will help prepare the Company for the day when it receives a twenty to thirty page document that the Investor will present as embodying the provisions of the Term Sheet.

VII. Signatures.

Although most of the provisions contained in the Term Sheet are not legally binding on the parties, it is nevertheless valuable to have it signed by all of the parties. The Term Sheet is one means of ensuring that any provisions regarding reimbursement of expenses will be binding upon the Company. An executed Term Sheet may be of considerable value to the Company. It can be used as persuasive evidence of the forthcoming Investment when the Company deals with lenders, creditors, suppliers, customers and others. Finally, the execution of the Term Sheet will confirm that the parties agree to its contents, keeping in mind that even an executed Term Sheet is not designed to force the Company or the Investor to consummate the transaction.

Appendix A

TERM SHEET

FOR SERIES A PREFERRED STOCK FINANCING OF

[***INSERT COMPANY NAME***], **INC.**

[_____ __, 20__]

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] provisions 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 [_____].

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: [_____] shares ([__]%), $[_____] Investor No. 2: [_____] 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].
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 on Exhibit A.

CHARTER

Dividends:

[*Alternative 1:* Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock]

[*Alternative 2:* The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.]

[*Alternative 3*: Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[_____] per share of Series A Preferred when and if declared by the Board.]

Liquidation Preference:

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

[*Alternative 1 (non-participating Preferred Stock)*: First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata 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. Thereafter, the Series A Preferred participates with the Common Stock pro rata 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. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).]

A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer, exclusive license 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 elect otherwise]. [The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to

escrow in connection with a Deemed Liquidation Event.]

Voting Rights: The Series A Preferred shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) [so long as [*insert fixed number, or %, or "any"*] shares of Series A Preferred are outstanding,] the Series A Preferred as a class shall be entitled to elect [_____] [(_)] members of the Board (the "**Series A Directors**"), and (ii) 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.

Protective Provisions: [So long as [*insert fixed number, or %, or "any"*] shares of Series A Preferred are outstanding,] in addition to any other vote or approval required under the Company's Charter or Bylaws, 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 merger or consolidation or any other 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][unless such debt security has received the prior approval of the Board of Directors, including the approval of [_____] Series A Director(s)]; (vi) create or hold capital stock in any subsidiary that is not a wholly-owned subsidiary or dispose of any subsidiary stock or all or substantially all of any subsidiary assets; [or (vii) increase or decrease the size of the Board of Directors].[1]

Optional Conversion: The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock

[1] The board size provision may also be addressed in the Voting Agreement; see Section 1.1 of the Model Voting Agreement.

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 conversion price, such conversion price shall be adjusted in accordance with the following formula:

[*Alternative 1:* "Typical" weighted average:

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

CP_2 = Series A Conversion Price in effect immediately after new issue

CP_1 = Series A Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)[2]

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.]

[*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, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; and (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [_____] Series A Director(s)].

2 The "broadest" base would include shares reserved in the option pool.

Mandatory Conversion:	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 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.
[*Pay-to-Play:*	[Unless the holders of [__]% of the Series A elect otherwise,] on any subsequent [down] round all [Major] Investors are required to purchase their pro rata share of the securities set aside by the Board for purchase by the [Major] Investors. All shares of Series A Preferred[3] 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].]
Redemption Rights:	Unless prohibited by Delaware law governing distributions to stockholders, the Series A Preferred shall be redeemable at the option of holders of at least [__]% of the Series A Preferred commencing any time after [_____] 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)].

[3] 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).

Representations and Warranties:	Standard representations and warranties by the Company. [Representations and warranties by Founders regarding technology ownership, etc.]. [Representations and warranties regarding CFIUS.]
[*Regulatory Covenants (CFIUS):*	*To the extent a CFIUS filing is or may be required:* Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("**CFIUS**") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]] [Notwithstanding the previous sentence, Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors' right to exercise control over the Company.]
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, [the obtaining of CFIUS clearance and/or a statement from CFIUS that no further review is necessary,] and an opinion of counsel to the Company.
Counsel and Expenses:	[Investor/Company] counsel to draft Closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed $[_____]) and expenses of Investor counsel [, unless the transaction is not completed because the Investors withdraw their commitment without cause]. Company Counsel: [_____ _____ _____] Investor Counsel: [_____ _____ _____]

INVESTORS' 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] will be deemed "**Registrable Securities**."

Demand Registration: 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 $[5-15] 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 [two] 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 [20-30]% 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 [(including/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 Investors, pro rata, based on the number of shares

held.

Termination: Upon a Deemed Liquidation Event, [and/or] when all shares of an Investor are eligible to be sold without restriction under Rule 144 [and/or] the [____] anniversary of the IPO**.**

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.

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. A "Major Investor" means any Investor who purchases at least $[_____] of Series A Preferred.

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), 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. In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

Matters Requiring Investor Director Approval: [So long as the holders of Series A Preferred are entitled to elect a Series A Director, the Company will not, without Board approval, which approval must include the affirmative vote of [one/both] 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 an 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 inconsistent with any investment policy approved by the Board; (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];[4] (vii) hire, fire, or change the compensation of the executive officers, including approving any option grants; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; (ix) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (x) enter into any corporate strategic relationship involving the payment contribution or assignment by the Company or to the Company of assets greater than [$100,000.00].

Non-Competition and Non-Solicitation Agreements: 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 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. Company to enter into Indemnification Agreement with each Series A Director [and affiliated funds] in form acceptable to such director. 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 the Company's obligations with respect to indemnification of Directors.

Employee Stock Options: All employee options to vest as follows: [25% after one year, with

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4 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.

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.]

[*Limitations on Pre-CFIUS-Approval Exercise of Rights:*

Notwithstanding anything to the contrary contained in the Transaction Agreements, Investors and the Company agree that as of and following the initial Closing and until the CFIUS clearance is received, Investors shall not obtain (i) control (as defined in 31 C.F.R. § 800.204) of the Company, including the power to determine, direct or decide any important matters for the Company; (ii) access to any material nonpublic technical information (as defined in 31 C.F.R. § 801.208) in the possession of the Company (which shall not include financial information about the Company), including access to any information not already in the public domain that is necessary to design, fabricate, develop, test, produce, or manufacture Company products, including processes, techniques, or methods; (iii) membership or observer rights on the Board of Directors of the Company or the right to nominate an individual to a position on the Board of Directors of the Company; or (iv) any involvement (other than through voting of shares) in substantive decision-making of the Company regarding the use, development, acquisition, or release of any of the Company's critical technologies (as defined in 31 C.F.R. § 801.204). To the extent that any term in the Transaction Agreements would grant any of these rights, (i)-(iv) to Investors, that term shall have no effect until such time as the CFIUS clearance is received.]

[*Springing CFIUS Covenant:*

[In the event that CFIUS requests or requires a filing/in the event of [ ]], Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("CFIUS") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]. Notwithstanding the previous sentence, Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors' right to exercise control over the Company.]

[*Limitations on Information Rights:*

Notwithstanding anything to the contrary contained in the Stock Purchase Agreement, the Charter, the Investors' Rights Agreement, the Right of First Refusal And Co-Sale Agreement, and the Voting Agreement (all of the agreements above together being the "**Transaction Agreements**"), Investors and the Company agree that as of and following [Closing/the initial Closing], Investors shall not obtain access to any material nonpublic technical information (as defined in 31 C.F.R. § 801.208) in the possession of the Company (which shall not include financial information about the Company), including access to any information not already in the public domain that is necessary to design, fabricate, develop, test,

produce, or manufacture Company products, including processes, techniques, or methods.]

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.

RIGHT OF FIRST REFUSAL/CO-SALE 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,) will have a right of first refusal with respect to any shares of capital stock of the Company proposed to be transferred by Founders [and future employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)], 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.

VOTING AGREEMENT

Board of Directors: 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].

[*Drag Along**:*** Holders of Preferred Stock and the Founders [and all 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 and which is approved by [the Board of Directors] [and the holders of ____% of the outstanding shares of Preferred Stock, on an as-converted basis (the "Electing Holders")]**,** so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder's pro rata portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Certificate of Incorporation.]

[*Sale Rights:* Upon written notice to the Company from the Electing Holders, the Company shall initiate a process intended to result in a sale of the Company.]

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:* The terms set forth above for the Series [_] Preferred 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 [_____] 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.

Expiration: This Term Sheet expires on [_____ __, 20__] if not accepted by the Company by that date.

EXECUTED THIS [__] DAY OF [_____], 20[__].

[SIGNATURE BLOCKS]

EXHIBIT A

Pre and Post-Financing Capitalization

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