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Chapter 5

Preparing a Venture Capital Term Sheet

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PREPARING A VENTURE CAPITAL TERM SHEET

The Company is growing and you have moved beyond angel financing. It is now time to begin courting venture capitalists. This chapter will help you structure the term sheet or investment by the venture capitalists into the Company.

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 merely a technicality; the choice of designation is largely one of personal preference with no substantive effect. For simplicity, in this section we use the phrase “term sheet” to describe the initial agreement as to the terms of the transaction.

By focusing on the term sheet, the Company and the venture capital investor (the Investor) can direct their attention to the major business and structural issues involved in the proposed investment. The parties may relatively quickly 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 process of preparing and negotiating a term sheet also helps solidify the transaction and 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 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 lenders, creditors, suppliers, customers, and others.

Each business will have unique issues, and the term sheet should focus on these issues. Generally, with respect to Internet, software, and other information technology companies, deal-breaking issues most often arise in the IP and employment areas. These issues should be addressed early in the transaction process, and the parties’ understanding should be reflected in the term sheet.

Ensuring That the Term Sheet Is Nonbinding

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.

One significant exception to the nonbinding nature of a term sheet often arises with regard to expenses. Term sheets frequently provide that, although the main provisions are nonbinding, certain expenses of the Investor are to be borne by the Company even if the transaction is never consummated; therefore, the term sheet should specifically mention that such provision is legally binding upon the parties. Increasingly, a term sheet includes a binding standstill provision whereby the Company agrees to negotiate exclusively with the Investor for some fixed period of time. Also, 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 maintaining confidentiality of the negotiation of the transaction itself.

Despite the nonbinding and summary nature of the term sheet, it is not uncommon for one of the parties to the term sheet, upon receipt of the first draft of the definitive agreements, to exclaim: "But this wasn't in the term sheet!" It is therefore important to include all key provisions in the term sheet while at the same time explicitly conveying the message to both parties that the term sheet will not contain every provision of the transaction as finally documented. A sample letter with a term sheet attached can be found at the end of this chapter.

Amount and Type of Investment

Amount of Investment

The term sheet should set forth the total dollar amount the Investor is prepared to invest in the Company and the percentage of the Company that the Investor will own on a postclosing, fully diluted basis, after all convertible securities, options, warrants, or other rights have been converted or exercised (sometimes with an exception for employee stock options granted at fair market value to employees other than the founders) and, depending on the terms of the business deal, after the calculation of all antidilution adjustments that would be triggered as a result of the transaction (if any). If the investment is intended to yield a current return (customarily in the form of a dividend), the amount of the return should be clearly specified. The Investor may desire to set forth in the term sheet how the investment proceeds should be used by the Company. The Investor may also desire to specify how the proceedings of a sale of the Company will be distributed through the liquidation preference discussed below.

Type of Securities

The term sheet should indicate the type of securities that the Investor contemplates purchasing, whether common stock, preferred stock, warrants, debt securities, partnership or membership interests, or some other type of securities, 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, and/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 special 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 in the section of this chapter titled “Investor’s Rights”).

We have assumed the Company is a corporate entity. However, increasingly, a limited liability company entity is preferred because the limited liability company (i) is taxed as a partnership for federal income tax purposes, (ii) provides limited liability to its members, and (iii) 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 Schedule K-1 information on their K-1s. A careful analysis should be made early on as to what the optimal entity structure for the Company would be after the investment. (See Chapter 1: Choosing the Ideal Structure for Your Business Entity.) If a noncorporate entity is chosen, a clause should be included in the term sheet providing for conversion to corporate form, and the mechanics therefor, prior to an initial public offering. Generally, the issues relating to the investment are similar, regardless of entity structure.

Security Mechanisms

If the Investor requires its investment in the Company to be secured in any manner (more common for subordinated debt investments), the term sheet should set forth the contemplated security mechanisms. For example, the Investor may require individual guarantees (which may or may not be limited to a specified dollar amount), pledges of stock that continues to be held by the founders, the assignment of insurance policies, or the granting of security interests in all or a portion of the Company’s assets.

Milestones

Because many life sciences companies become less valuable or even worthless if key preclinical and clinical milestones are not met, increasingly investors are staging life sciences venture capital investments to contribute a certain dollar amount deemed necessary to find out if a key milestone will be met and the balance upon achieving the milestone.

Investor’s Rights

The term sheet should explain the Investor’s rights, which will be contained in the terms of the definitive agreements (preferred stock terms for corporate entity, operating agreement for a limited liability company, or partnership agreement for a partnership). In the context of an investment in preferred stock, which remains the most common security, the following rights may be included.

Conversion Rights

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 and/or mandatory conversion) and the conversion ratio (whether 1:1, 2:1, and so forth) upon which the conversion is to be based. If the securities will be subject to mandatory conversion, the events that trigger such a conversion should be set forth. Typical events that trigger mandatory conversion include the occurrence of a public offering of stock of the Company at certain prices or the affirmative vote of the holders of a majority or supermajority of the securities. In addition, if the conversion ratio is designed to fluctuate over time as a means of protecting the investment against dilution, it should be stated in the term sheet (see discussion on antidilution rights in the next section).

Antidilution Rights

The term sheet should indicate whether the Investor will be entitled to protection against dilution of the Investor's investment to the extent that the Company later issues securities at a price that is less than the price paid by the Investor. If the Investor is entitled to antidilution protection, the ratio at which the Investor's shares of preferred stock will convert into shares of common stock will fluctuate based on the issuance price of the new securities. The term sheet should set forth the mechanism for adjusting the conversion ratio (e.g., a "full ratchet" or an averaging provision of some type). The term sheet should also specify the events upon which such adjustment is predicated (i.e., the issuance of common stock, or securities convertible into common stock, at a price less than then current conversion price of preferred stock) and any exceptions to such events (e.g., there may be no antidilution adjustments for options granted to employees or for securities issued in connection with corporate transactions such as leases or licenses that are primarily of a nonequity financing nature).

Redemption/Repurchase Rights

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 could occur. For instance, the term sheet should indicate whether the redemption/repurchase is to be optional (and at whose option) or mandatory, when the obligation to redeem/repurchase will arise (e.g., on the death of a principal in the Company, a public offering, or a particular date), whether the redemption/repurchase obligation applies to only unconverted or unexercised securities or also to the shares of common stock received upon such conversion or exercise, the price (or method of computing the price) at which the redemption/repurchase will occur, and the consequences for the failure to redeem (e.g., loss of the ability to elect additional directors and control the board).

Rights Upon Liquidation

The term sheet should indicate whether the Investor has a preference upon liquidation. If the venture proves to be unsuccessful, the Investor who provided the last funds to the Company often will get first opportunity to recover its investment. There are three customary structures for a liquidation preference: (i) a simple preference where the Investor has the right to a return of its investment out of the initial funds distributed to stockholders or the Investor can convert to common stock and

share the proceeds with all stockholders if that would yield the Investor a higher return; (ii) a participating preference in which the Investor receives a return of its investment and also participates in its share of the excess proceeds with all stockholders; and (iii) a multiple preference, which is similar to (i) above, but which provides the Investor with a preferred negotiated profit. The liquidation preference is important because it determines how sale proceeds will be distributed, and while most companies hope for an initial public offering exit, they usually achieve a sale exit.

Rights to Dividends

The term sheet should indicate whether the Investor is entitled to any special dividends or other preferential return on the securities it purchases, whether such dividends will accumulate to the extent not paid, and whether the holders of common stock or any other junior securities may receive dividends or other distributions if accumulated dividends owing to the Investor are not paid. In addition, the term sheet should state whether the Investor is entitled to share in the dividends declared with respect to existing shares of common stock and whether the Investor is entitled to receive accumulated dividends upon conversion, redemption, or liquidation.

Voting Rights and Board Representation

The nature of the Investor's voting rights should be indicated in the term sheet. Most commonly, the Investor 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 also 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. The Investor will often have the right to elect (or otherwise appoint for election by the Company's shareholders) one or more members of the board of directors of the Company. The term sheet should also set forth the means for effectuating these provisions. The preferred method is a required amendment to the Company's Articles or Certificate of Incorporation that provides for election to the board of directors of a representative of 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 (preferably all) of the existing shareholders of the Company should execute a shareholders' 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.

Registration Rights

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 when, during what period, and how frequently the Investor can demand registration

of its shares; whether the Investor receives piggyback and/or demand registration rights; and who pays the expenses of each such registration.

Preemptive/First Refusal/Co-Sale/Tag-Along Rights

If the Investor is to have preemptive rights (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), a right of first refusal (right of the Investor to be first offered securities to be sold by other shareholders and/or the Company), a right of co-sale (right of the Investor to sell its securities along with any securities sold by the Company or the other shareholders), or tag-along rights (right to obligate other shareholders to sell their securities along with securities sold by the Investor), these rights should be set forth in the term sheet and will generally terminate upon an initial public offering of common stock by the Company.

Information Rights

If the Investor is a minority investor, the Investor will typically desire the right, which should be specified in the term sheet, to receive monthly and/or quarterly financial statements, an annual audited financial statement, and an annual budget, as well as the ability to have interim access to the books and records of the Company.

Representations, Warranties, Covenants, and Other Agreements

Representations and Warranties

It is usually not necessary to set forth in the term sheet all of the representations and warranties that will be requested of the Company. It is often 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.

Rights to IP

The term sheet should specify any issues relating to the Company’s IP 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. IP is obviously a very important, if not the most important, asset for most life sciences companies.

Agreements Binding Founders/Key Employees

The term sheet should set forth the restrictions to be imposed upon the founders and other key employees, including employment agreements with top management; noncompetition agreements with officers, key scientists, and other key employees; restrictions on the sale of securities of the Company held by a founder or manager; and, particularly for technology companies, proprietary information and inventions agreements with all key employees and consultants to the Company. The

Investor may also require the Company to maintain “key man” life insurance on the members of the top management.

Other Affirmative and Negative Covenants

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 Articles or Certificate of Incorporation or bylaws limiting director liability (to the extent available). The term sheet should also refer to appropriate negative covenants, such as the Company not merging, selling the assets, or otherwise implementing any fundamental changes in its business without Investor approval; not amending the Articles or Certificate of Incorporation or bylaws without Investor approval; or not creating or issuing any additional shares of capital stock without the approval of the Investor. In addition, the term sheet should provide that other “standard and customary covenants” will be included in the final agreements.

Default

The term sheet should set forth the events that will constitute a default, which are particularly common in subordinated debt financings. Such events may include, among other things, breach of any of the representations, warranties, or covenants contained in the final agreements; the death of one or more of the principals of the Company; failure to make any payment required under the final agreements; bankruptcy, insolvency, or similar events; the entry of the Company into any unrelated business activity; defaults under any existing senior financing documents; or the existence of losses over some period of time. The term sheet should note whether any grace periods will be allowed and whether any notice of default will be given by the Investor. The term sheet should also indicate the remedies available to the Investor upon the occurrence of an event of default, such as the right to require the redemption/repurchase of the securities, an increase in any applicable interest rates, the right to elect or select a majority of the board of directors of the Company, or the right to indemnification.

Conditions to Closing

The term sheet should also set forth any conditions required to be met prior to the closing of the final agreements. Such conditions should include continuing due diligence by the Investor up until the closing and the execution of the final agreements. There may also be certain requirements of the Company, such as the production of audited/reviewed financial statements, the generation of satisfactory financial projections, the production of a satisfactory business plan, the completion of a scientific study or other preclinical data, and/or the selection of satisfactory legal counsel and/or accountants. It is also important that the term sheet specify whether Company counsel will be required to issue an opinion letter at or prior to closing.

The term sheet should also indicate whether the Company or its officers, directors, or shareholders are required to execute any agreements in addition to the final purchase agreement prior

to or at the closing. For example, the Investor may want a voting trust, a shareholders' agreement, security or pledge agreements, or an employment agreement. The Investor may also want the current shareholders to waive their antidilution protection for purposes of this round of financing if this is a "down" round.

Often, third parties are required to act prior to or at the closing. If so, the term sheet should clearly indicate what actions must be taken. The particular transactions may require the receipt of the approval of state securities agencies of the offer and sale of the securities, a clear assignment of patent rights, a waiver of claims, the conversion of debt into equity, or the receipt of a loan commitment from a bank.

To the extent there will be multiple closings, the representations and warranties should be "brought down" so that they are true at the time of each such closing, just as they were required to be true at the initial closing.

Fees

If there are finder's or broker's fees, the term sheet should indicate who is responsible for paying them. The term sheet should also indicate whether and to what extent the Company will be responsible for paying the Investor's legal fees.

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 20- to 60-page document that the Investor will present as embodying the provisions of the term sheet.

Signatures

Although most of the provisions contained in the term sheet are not binding on the parties, it is nevertheless valuable to have it signed by all of the parties. The term sheet also is one means of ensuring that any provisions regarding reimbursement of expenses will be binding upon the Company. In addition, 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 serve to confirm that the parties actually 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.

Form of Term Sheet/Letter of Intent

The sample term sheet on the next page is designed to differentiate binding provisions of the letter of intent from the nonbinding summary of terms by attaching the terms to a letter agreement.

This term sheet reflects a conventional preferred stock investment incorporating many of the terms discussed in this chapter and including alternatives frequently considered by venture capital investors.

SAMPLE TERM SHEET

[ABC VENTURE FUND LETTERHEAD]

[Date]

[Name of Company]

[Address of Company]

[Address of Company]

Attention: [Company Contact Person]

Re: Investment in [Name of Company]

Dear [Company Contact Person]:

This letter summarizes our understanding concerning the possible investment by ABC Venture Fund (ABC) in [Name of Company], a [State of Incorporation] corporation (the Company), which [briefly describe business].

1. Terms. The principal terms of the investment and related transactions (the Investment) are set forth in the Summary of Principal Terms attached as Exhibit A to this letter.

2. Conditions. Any obligation of ABC to consummate the proposed investment will be subject to, among other conditions, satisfactory completion by ABC of its due diligence relating to the Company (including routine background checks on senior management) and agreement by ABC and the Company as to the definitive agreements regarding the Investment.

3. Confidentiality of Information. ABC agrees to hold in strict confidence all information concerning the business and affairs of the Company obtained from the Company and its agents (the Confidential Material); to use such information solely for the purpose of evaluating the Investment; and to only make available such information to such officers, employees, and representatives (including legal and accounting representatives) as is necessary for ABC to evaluate the investment or as may be required by law or regulation or to comply with the requirements or receipt of approval of an applicable governing agency (including ABC's obligations pursuant to the Small Business Investment Act of 1958, as amended, and the regulations thereunder). However, Confidential Material does not include any such information that (i) is or becomes available to the public other than as a result of a disclosure by the Company, (ii) was known to ABC on a nonconfidential basis prior to its disclosure by the Company, or (iii) becomes available to ABC on a nonconfidential basis from a source other than the Company or its agents, provided that such source is not bound by a confidentiality agreement with the Company known to ABC. If the Investment is not consummated, ABC will return or destroy all information so obtained. ABC and the Company agree that they will not issue a press release or make any public statement regarding the Investment until the definitive agreement is signed by all parties and, after the definitive purchase agreement is signed, that ABC and the Company will consult with each other before issuing any press releases or otherwise making any public statements with respect to the Investment.

4. Exclusivity. In consideration of the time, expense, and effort that has been, and will be, incurred by ABC in considering the Investment, and until termination as provided in paragraph 6 hereof, neither the Company nor its officers, directors, or representatives will solicit, encourage offers from, or provide Confidential Material to any other parties with respect to the sale of assets, stock, or other ownership interests in the business of the Company, except as it relates to the Investment. The Company agrees to promptly notify ABC if the Company receives an unsolicited offer or solicitation of interest to buy assets, stock, or other ownership interests in the business of the Company, except as it relates to the Investment.

5. Expenses. The Company will bear the legal fees and other out-of-pocket expenses of ABC with respect to the Investment, up to a maximum of \$_____, regardless of whether or not the Investment is consummated.

6. Termination. If the parties are unable to agree on the terms and conditions of a definitive agreement by [e.g., 60 days after the date of this letter], then this letter (and Exhibit A hereto) shall expire and neither party shall have any further rights, duties, or obligations hereunder, except for the obligation of ABC set forth in paragraph 3 regarding Confidential Information and the obligation of the Company to reimburse ABC for its expenses pursuant to paragraph 5 hereof. Upon signing and returning a counterpart of this letter, our attorneys will proceed to prepare a definitive agreement containing such provisions as are set forth in Exhibit A. Except for the agreements in paragraphs 3, 4, 5, and 6 of this letter, which shall be legally binding upon execution of this letter, this letter is not intended as an offer or a legally binding commitment by ABC, and any obligation on the part of either ABC or the Company to proceed is dependent upon the execution by the parties of a definitive agreement.

This letter shall be governed by the laws of the [Insert State].

If this letter correctly sets forth your understanding, please sign the enclosed copy in the space provided below and return it to us at your earliest convenience. If we have not received a fully executed copy by _____, we will consider our proposal to have been rejected and it will be deemed withdrawn without further notice or other action on our part.

Very truly yours,

ABC VENTURE FUND

By: ABC Venture Fund,
its general partner

By: _____

By: _____
Name:
Title:

ACKNOWLEDGED, APPROVED, AND ACCEPTED:

[Name of Company]

By: _____

Name:

EXHIBIT A

SUMMARY OF PRINCIPAL TERMS

Issuer

[Name of Company], a [State of Incorporation] corporation (the Company)

Amount

\$_____

Investors

ABC Venture Fund

\$_____

Other Investors

\$_____

Total

\$_____

(collectively referred to as the Investors)

Pro Forma Capitalization

Common Stock _____%

Options _____%

Investors _____%

Total 100%

Use of Proceeds

The funds will be used [for general working capital purposes]. No part of the proceeds may be used to make payments to any affiliate or stockholder of the Company (other than in ordinary arm's-length commercial transactions or any payments with respect to a person's employment by or activities on behalf of the Company).

Security

_____ shares of Series [A] Convertible Preferred Stock (the Preferred) of the Company at a price of \$_____ per share (Original Purchase Price)

Rights, Preferences, Privileges, and Restrictions of Preferred

(1) Voluntary Conversion: Each share of the Preferred will be convertible at any time, at the option of the holder, into common stock of the Company (Common Stock) at the then applicable conversion rate (which initially shall provide

for the conversion of each share of the Preferred into one share of Common Stock). The conversion rate will be subject to appropriate adjustment in the event of stock splits, stock dividends, recapitalizations, and so forth, as set forth below. [Any and all accrued and unpaid dividends on the Preferred shall be payable upon conversion.]

(2) Automatic Conversion: The Preferred will be automatically converted into Common Stock, at the then applicable conversion rate, (a) in the event of an underwritten public offering of shares of the Common Stock at a public offering price of not less than \$_____ per share [e.g., five times original purchase price] in which the net proceeds to the Company are not less than \$25,000,000 or (b) upon the vote of holders of 66-2/3% of the then outstanding shares of the Preferred.

(3) Antidilution Protection: The conversion price will be subject to proportional adjustments for capital reorganizations, reclassifications, or other changes. In addition, the conversion price will be adjusted on a weighted average basis for issuances of Common Stock or Common Stock equivalents at any time after the sale of the Preferred to the Investors below the conversion price then in effect other than the issuance of Reserved Employee Shares (as hereinafter defined).

(4) Liquidation: In the event of any liquidation or winding up of the Company, the holders of the Preferred will be entitled to receive in preference to the holders of Common Stock an amount equal to (a) the Original Purchase Price plus (b) any dividends accumulated on the Preferred but not paid (the Liquidation Preference). After the payment of such preference, the holders of the Preferred will share with the holders of the Common Stock any remaining assets of the Company on an as-converted basis until the amount paid to the holders of the Preferred equals [three times the Liquidation Preference]. A consolidation or merger of the Company or sale of substantially all of its assets shall be deemed to be a liquidation or winding up for purposes of the Liquidation Preference.

(5) Mandatory Redemption: The Preferred shall be redeemable at the holders' option after the fifth anniversary of the issuance of the Preferred at the Original Purchase Price plus an amount per share equal to 1% of the Original Purchase Price multiplied by the number of complete calendar months since the date of issuance of the Preferred.

(6) Dividend Provisions: The Preferred shall be entitled to dividends at the same rate as the Common Stock (based on the number of shares of Common Stock into which the Preferred is convertible on the date the dividend is declared). In addition, holders of the Preferred will be entitled to a preferred dividend at the rate of 8% per annum. Dividends on the Preferred will be cumulative (whether or not declared by the Company). The Company shall not repurchase any shares of Common Stock or pay any dividends on the Common Stock while the dividends on the Preferred are in arrears.

(7) Voting Rights: The holders of the Preferred will have the right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of the Preferred. Election of directors will be as described in the section titled "Board Representation" below.

(8) Protective Provisions: The consent of the holders of a majority of the Preferred, voting separately as a class, is required for any of the following actions: (a) any sale, merger, acquisition, consolidation, recapitalization, liquidation, or initial public offering; (b) sale of any assets other than inventory in the ordinary course of business; (c) any amendments to the Company's Certificate of Incorporation or bylaws; (d) increase in the number of directors; (e) alteration or change in the rights, preferences, or privileges of the Preferred; (f) increase in the authorized number of shares of the Preferred; (g) creation of a new class of shares having preferences senior to or on parity with the Preferred; (h) payment of a dividend on the Common Stock; (i) any repurchase or other acquisition of shares of the Company's capital stock (other than pursuant to the redemption provisions described above or repurchases from employees, directors, and consultants pursuant to agreements providing the Company with repurchase rights upon the termination of their service to the Company); and (j) other reasonable covenants identified after completion of due diligence.

Registration Rights

(1) Demand Rights: If, at any time after the earlier of (a) the date five years from the purchase of the Preferred or (b) six months after the effective date of the Company's initial public offering, Investors holding at least a majority of the Preferred (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and the Preferred) request that the Company file a registration statement for at least 30% of the Preferred (or Common Stock issued upon conversion of the Preferred) or any lesser percentage if the anticipated aggregate offering price to the public would exceed \$5,000,000, the Company will use its best efforts to cause such shares to be registered. The Company will not be obligated to effect more than two registrations (other than on Form S-3) under these demand rights provisions.

(2) Registration on Form S-3: In addition to the rights under paragraph (1) above, holders of 25% or more of the Preferred (or Common Stock issued upon conversion of the Preferred) will have the right to require the Company to file an unlimited number of registration statements on Form S-3, if such form is available, registering at least \$1,000,000 of securities.

(3) Piggyback Registration: The Investor will be entitled to unlimited piggyback registration rights on all registrations of the Company (including in connection with the Company's initial public offering, but excluding registrations on Form S-8, S-4, or any similar or successor form), subject to underwriters' cutbacks.

(4) Registration Expenses: All registration expenses for the registrations required under paragraphs (1), (2), and (3) above (exclusive of underwriting discounts and commissions) shall be borne by the Company, including the fees relating to special counsel for the selling stockholder(s).

(5) Termination of Registration Rights: The registration obligations of the Company shall terminate with respect to any particular security, if such security may be sold by the holder thereof in a three-month period pursuant to Rule 144.

Stockholders' Agreement

(1) Right of First Offer: So long as an Investor is a holder of not less than 10% of the Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred), if the Company proposes to offer any shares for the purpose of financing its business (other than shares issued to employees, consultants, or directors pursuant to a stock option plan; shares issued in connection with the acquisition of another company; or shares offered to the public pursuant to an underwritten public offering), the Company will first offer all of such shares to Investors. The right of first offer will terminate upon an underwritten public offering of shares of the Company.

(2) Right of First Refusal: The Company, and then the Investors, will have a right of first refusal with respect to any proposed resale of Common Stock by any current common stockholder, which right will terminate upon a public offering.

(3) Co-Sale Provision: The holders of Common Stock will grant the Investors a right to participate on a pro rata basis in any sales of the Company's Common Stock made by a holder of Common Stock.

(4) Tag-Along Provision: The current holders of Common Stock will agree to enter into any sale transaction with respect to their Common Stock that is approved and entered into by the holders of at least 75% of the issued and outstanding capital stock of the Company.

Information Rights

So long as an Investor continues to hold shares of the Preferred or Common Stock issued upon conversion of the Preferred, the Company (i) will timely furnish the Investor with annual, quarterly, and monthly (actual to budget) financial statements and (ii) will furnish at least 60 days before the end of each fiscal year a budget (including projected income statement, cash flow, and balance sheet) for the ensuing fiscal year, together with underlying assumptions. So long as an Investor holds not less than 10% of the total Preferred issued in the financing, representatives of the Investor will have the right to inspect the books and records of the Company. Annual statements must be audited by a firm of independent accountants reasonably acceptable to the Investors, or may be reviewed by such firm if the Company is given assurances regarding the ability to audit retroactively such statements for a period of at least three years thereafter. The obligation of the Company to furnish budgets and financial statements will terminate upon a public offering of the Common Stock of the Company.

Board Representation

The board will consist of five members to be selected as follows: (i) two shall be nominated by the holders of the Preferred, (ii) two shall be nominated by the holders of Common Stock [one of which shall be the Company's chief executive officer], and (iii) one shall be independent and shall be nominated by the board.

The board of directors will form an audit committee and a compensation committee. The compensation committee will set the compensation of each executive officer and approve all grants of stock options. A representative of ABC shall be a member of each committee.

The Company will reimburse each nonemployee director for his or her reasonable expenses incurred in attending meetings of the board of directors and committees thereof.

The charter or bylaws will contain appropriate protective provisions to the fullest extent available under applicable law.

Stock Restriction Agreement

The founders and all other holders of the Common Stock of the Company who are employees will execute a stock restriction agreement with the Company pursuant to which the Company will have a repurchase option to buy back, at cost, a portion of the shares of Common Stock held by such person in the event that such stockholder's employment with the Company is terminated for any reason other than without cause prior to the expiration of 48 months from the date of the purchase of the Preferred or the date of employment, whichever is later (the Measuring Date). A portion of the shares will be released from the repurchase option based upon continued employment by the Company as follows: 25% will be released from the repurchase option on each of the first four anniversaries of the Measuring Date; however, upon a change of control or sale of all or substantially all of the assets of the Company, all the shares will be released from the repurchase option.

Nondisclosure and Inventions Assignment Agreement

All employees of the Company will enter into a nondisclosure and inventions assignment agreement in the form to be provided by the Investors. The agreement with each executive officer and key employees shall also contain a two-year noncompetition and nonsolicitation agreement.

Key Man Insurance

The Company shall obtain and maintain term life insurance with respect to [] in the minimum amount of \$_____ with the proceeds payable to the Company.

Reserved Employee Shares

The Company may reserve up to _____ % [e.g., 15%] of shares of common stock (the Reserved Employee Shares), including shares presently reserved, for issuance upon the exercise of options to employees, directors, and consultants. Reserved Employee Shares will be issued from time to time under such agreements, contracts, or plans as are recommended by management and approved by the board of directors. Issuance of shares to employees in excess of the Reserved Employee Shares will be dilutive, requiring adjustment to the conversion price provided above. The plan will provide the Company with the option to repurchase shares issued upon exercise of options upon termination of employment.

Purchase Agreement

The purchase of the Preferred will be made pursuant to a stock purchase agreement, drafted by counsel to the Investors, which agreement shall contain, among other things:

- (1) Representations and Warranties: Standard and customary representations and warranties of the Company.
- (2) Covenants: Standard and customary covenants of the Company, including those set forth above.
- (3) [If the investor is an SBIC add the following:] SBIC Side Letter: Standard and customary provisions required pursuant to the Small Business Investment Act of 1958, as amended, and the regulations thereunder.
- (4) Conditions to Closing: Standard and customary conditions of closing, including no adverse developments, satisfactory conclusion by the Investors of their due-diligence investigation (including routine background checks on senior management), and receipt of an opinion of counsel to the Company.

The Purchase Agreement will also contain such other customary provisions as may be appropriate for this investment.