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## **GREEN BUSINESS SUMMIT II**

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### **PREPARING A CLEANTECH COMPANY FOR A VENTURE CAPITAL TERM SHEET**

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## COUNSELING A CLEANTECH COMPANY

### PREPARING A VENTURE CAPITAL TERM SHEET

#### 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 the 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 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 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 lenders, creditors, suppliers, customers and others.

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

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

Merely because the document which 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 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; therefore, the Term Sheet should specifically provide that the parties are

legally bound by such a provision. Increasingly, Term Sheets include 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 non-binding and summary nature of the Term Sheet, it is not uncommon for a Company, 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 the Company that the Term Sheet will not contain every provision of the transaction as finally documented.

### Type and Amount of Investment.

#### Amount of Investment.

The Term Sheet should set forth the total dollar amount the Investor is prepared to invest in the Company (the “Investment”), as well as the percentage of the Company which the Investor will own, on a post-closing, 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 anti-dilution 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 this return should be clearly specified. The Investor may desire to set forth in the Term Sheet the use of the Investment proceeds by the Company.

#### Type of Securities.

The Term Sheet should indicate the type of securities which 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 below under “Investor’s Rights”).

This article assumes the Company is a corporate entity. However, increasingly, a limited liability company entity is preferred since the limited liability company (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 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 which 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.

#### 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, these rights include the following:

#### 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 one-for-one, one-for-two, etc.) upon which the conversion is to be based. If, as a means of protecting their investment against dilution, the conversion ratio is designed to fluctuate over time, this should be stated in the Term Sheet. The Term Sheet should also describe in summary form the type of anti-dilution protection the Investor will have (e.g., a "full ratchet" or an averaging provision of some type), and should specify the event upon which such fluctuation is predicated (i.e., the issuance of common stock, or securities convertible into common stock, at a price less than the then current conversion price of the preferred stock).

#### 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., 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. 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 proceeds among holders of common stock, on an as-converted basis. If the investment is in common stock, it is still possible, but only through a complex sharing agreement entered into among the Investor and the other shareholders, to provide the Investor with a preference upon liquidation.

#### 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 holder 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 a 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 or (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 drag-along right (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 which 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 which 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 Intellectual Property.

The Term Sheet should specify any issues relating to intellectual property of the Company which either the Investor is relying upon in making its investment decision or which will need to be contributed by the founder to the Company or otherwise resolved prior to Closing.

### 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, non-competition agreements with officers, salesmen 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 lives 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, which are required to be met by the Company, such as an amendment to the Company’s Articles or Certificate of Incorporation or by-laws 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; not amending the Articles or Certificate of Incorporation or by-laws without Investor approval; or not creating or issuing any additional shares of capital stock, each 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 itself 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, and/or the selection of satisfactory legal counsel and/or accountants. It is also important that the Term Sheet specify if 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 anti-dilution 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 must be done. 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 twenty to sixty 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 attached form of Term Sheet is designed to differentiate binding provisions of the letter of intent from the non binding summary of terms by attaching the terms to a letter

agreement. This sample Term Sheet reflects a conventional preferred stock investment incorporating many of the terms discussed in this article, and including alternatives frequently considered by venture capital investors.

Appendix A

SAMPLE FORM OF TERM SHEET

[Name of Investor Group]

[Date]

[Name of Company]

Attention: [Company Contact Person]

Re: Investment in [Name of Company]

Dear \_\_\_\_\_:

This letter summarizes our understanding concerning the possible investment by \_\_\_\_\_ or one of its affiliates (the “Investor”) in \_\_\_\_\_, a \_\_\_\_\_ corporation (the “Company”), which [briefly describe business].

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.

Conditions. Any obligations of the parties to consummate the proposed investment will be subject to, among other conditions, satisfactory completion by the Investor of its due diligence relating to the Company and agreement by the Investor and the Company as to the definitive agreement regarding the Investment.

Confidentiality of Information. The Investor 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 the Investor 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. However, “Confidential Material” does not include any such information which (i) is or becomes available to the public other than as a result of a disclosure by the Company, (ii) was known to the Investor on a nonconfidential basis prior to its disclosure by the Company, or (iii) becomes available to the Investor 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 the Investor. If the Investment is not consummated, the Investor will return or destroy all information so obtained. The Investor 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 the Investor and the Company will consult with each other before issuing any press releases or otherwise making any public statements with respect to the Investment.

Exclusivity. In consideration of the time, expense and effort, which has, and will become, incurred by the Investor in considering the investment, and until termination is 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 the Investor 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.

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

Termination. If the parties are unable to agree on the terms and conditions of a definitive agreement by \_\_\_\_\_, then this letter (and the Exhibit hereto) shall expire and neither party shall have any further rights, duties and obligations hereunder, except for the obligation of the Company to reimburse the Investor for its expenses pursuant to Section 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 the Investor, and any obligation on the part of either the Investor 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 \_\_\_\_\_.

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,

[Name of Investor]

By: \_\_\_\_\_

ACKNOWLEDGED, APPROVED AND  
ACCEPTED:

[Name of Company]

By: \_\_\_\_\_

Name:

Title:

## SUMMARY OF PRINCIPAL TERMS

Amount: \$\_\_\_\_\_. The funds will be used to \_\_\_\_\_  
\_\_\_\_\_.

Security: \_\_\_\_\_ shares of Series A Convertible Preferred Stock (the “Preferred”) of the Company at a price of \$\_\_\_\_\_ per share (“Original Purchase Price”), representing, assuming conversion as provided below and the exercise of all outstanding options, \_\_\_% of the capital stock of the Company.

Rights, Preferences, Privileges and Restrictions of Preferred Stock:

(1) Conversion: Each share of Preferred will be convertible at any time, at the option of the holder, into \_\_\_\_\_ shares of Common Stock of the Company (“Common Stock”). The conversion rate will be subject to appropriate adjustment in the event of stock splits, stock dividends, recapitalizations, etc. 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, in the event of an underwritten public offering of shares of the Common Stock at a price of not less than \$\_\_\_\_\_ per share in which the net proceeds to the Company are not less than \$\_\_\_\_\_.

OR

(2) All Preferred will be automatically converted into Common Stock, at the then applicable conversion rate, in event of conversion into Common Stock of at least 2/3 of the Preferred issued at the financing, and in the event of an underwritten public offering of shares of the Common Stock.

(3) Mandatory Redemption. Redeemable at the holders’ option [or at the Company’s option] at [alternative 1] the Original Purchase Price (plus accrued or accumulated and unpaid dividends thereon) or [alternative 2] the Original

Purchase Price plus an amount per share equal to \_\_\_% of the Original Purchase Price multiplied by the number of complete calendar months since the date of issuance of the Preferred] or [alternative 3] a multiple of five (5) times annual earnings based upon the average of the two (2) prior fiscal years divided by the total number of shares issued and outstanding (assuming conversion of the Preferred) upon [alternative 1] the death or other termination of employment of \_\_\_\_\_ (the “Founder”), or [alternative 2] the fifth anniversary of the issuance of the Preferred.)

(4) Liquidation Preference: In the event of any liquidation of the Company, the Preferred will be entitled to receive in preference to the Common Stock an amount determined as follows (plus all accrued [accumulated] and unpaid dividends to the date of redemption):

<b>Date of Liquidation</b>	<b>Liquidation Preference</b>
Prior to _____	\$ _____
_____ - _____	\$ _____
_____ - _____	\$ _____
On or after _____	\$ _____

OR

(4) 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 the Original Purchase Price plus any dividends accumulated on the Preferred but not paid [and, after the payment of such preference, will share with the holders of the Common Stock any remaining assets of the Company on an as-converted basis.] A consolidation or merger of the Company or sale of substantially all of the assets shall be deemed to be a liquidation or winding up for purposes of the liquidation preference.

(5) 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.

(6) Voting Rights: Except as provided below and with respect to election of directors, the holder of a share of 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 under “Board Representation” below.

OR

(6) The holders of 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. In addition, the consent of the holders of the Preferred, voting separately as a class, is required for any of the following actions: (i) any sale, merger, acquisition, consolidation, recapitalization, liquidation or initial public offering; (ii) sale of any assets other than inventory in the ordinary course of business; (iii) any amendments to the Company’s articles of incorporation or bylaws; (iv) increase in the number of directors; (v) alteration or change in the rights, preferences or privileges of the Preferred materially and adversely; (vi) increase in the authorized number of shares of the Preferred; (vii) creation of a new class of shares having preferences senior to or on parity with the Preferred; (viii) payment of a dividend on the Common Stock; or (ix) other reasonable covenants used in similar financing;

(7) 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 [alternative 1] on a weighted average basis for issuance of Common Stock or Common Stock equivalents below the conversion prices other than the issuance of up to a maximum of \_\_\_\_\_ shares of Common Stock to employees, directors or consultants pursuant to a Company Stock Option Plan or [alternative 2] on a full ratchet basis where the price will drop to the lowest price at which the Common Stock or Common Stock equivalents are issued at any time after the sale of the

Preferred to the Investor. The Preferred will be treated identically with the Common Stock upon reorganizations, mergers, sales of assets or stock splits [modify when appropriate to protect minimum return provided for under “Dividends” or “Liquidation,” above].

Registration Rights:

(1) Demand Rights: If, at any time after the date [3 to 5] years from the purchase of the Preferred (but not within six (6) months of the effective date of a registration), 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 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 \$2,000,000, 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 (2) 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), 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) Piggy-Back Registration: The Investor will be entitled to unlimited “piggy-back” 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’ cut-backs.

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

(5) Termination of Registration Rights: The registration obligations of the Company shall terminate on the second

anniversary of the consummation of the first firm commitment underwritten public offering of the Company's securities pursuant to an effective registration statement under the Securities Act; or with respect to any particular security, if such security may be sold by the holder thereof in a three (3) month period pursuant to Rule 144.

Shareholders Agreement:

(1) Preemptive Right: The Investor will have a right of first refusal with respect to any proposed sale of Common Stock or securities convertible into Common Stock by the Company to the extent necessary for the Investor to maintain its percentage interest in the Common Stock on an as converted basis, which right will terminate upon a public offering.

OR

(1) So long as an investor is a holder of not less than 20% 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.

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

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

(5) Tag-Along Provision: The current holders of Common Stock will agree to enter into any sale transaction with respect to their Common Stock of the Company that is approved and entered into by the holders

of a majority of the issued and outstanding capital stock of the Company.

**Information Rights:**

So long as an investor continues to hold shares of Preferred or Common Stock issued upon conversion of the Preferred, the Company will timely furnish the Investor with annual, quarterly and monthly (actual to budget) financial statements. So long as the 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 Investor, 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 \_\_\_\_\_ members. Unless a default under the Purchase Agreement occurs, and is continuing, the Preferred will elect \_\_\_\_\_ directors, and the Common will elect \_\_\_\_\_ directors. After the closing of the sale of the Preferred, the Board will consist of \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_. The charter or by-laws will contain appropriate protective provisions under the \_\_\_\_\_ Directors' Liability Act.

**Employment Contract:**

The Company shall enter into a [term] employment contract with the Founder, providing for a monthly salary of not more than \$\_\_\_\_\_ and appropriate non-disclosure and non-competition covenants effective during the employment term.

**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 shareholder'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 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; provided, 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.

- Non-competition Agreements: The Company shall enter into two-year non-competition agreements with all officers and key employees. All existing employment agreements will be terminated.
- Proprietary Information and Inventions Agreement: All key employees of and consultants to the Company will enter into a proprietary information and inventions agreements in a form reasonably acceptable to the Investor.
- Key Man Insurance: The Company shall obtain and maintain term life insurance on the Founder in the minimum amount of \$\_\_\_\_\_ with the proceeds payable to the Company.
- Reserved Employee Shares: The Company may reserve up to \_\_\_\_\_ shares of common stock (the "Reserved Employees Shares") including shares presently reserved for issuance upon the exercise of outstanding options for issuance to employees. The Reserved Employees 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 prices provided above. Holders of the Reserved Employee Shares will be required to execute a stock restriction agreement.
- The Purchase Agreement: The purchase of the Preferred will be made pursuant to a Stock Purchase Agreement, drafted by counsel to the Investor, 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 and covenants restricting the Company from merging, selling its assets or otherwise implementing any fundamental changes, or

issuing any class of stock senior to the Preferred Stock or at a price below the Original Purchase Price on a fully converted basis, without the prior written consent of the Investor.

(3) Conditions to Closing: Standard and customary conditions of closing, including no adverse developments, satisfactory conclusion by the Investor of its due diligence investigation and receipt of an opinion of counsel as to the due organization and valid existence of the Company, the due authorization and execution of the Purchase Agreement and related agreements by the Company and the due issuance of the Preferred Stock to the Investor.

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