

APPENDIX 12

EXPLANATORY TERM SHEET (SAMPLE 2)

This term sheet summarizes the principal terms with respect to a potential private placement of equity securities of _____ (the “Company”) by a group of investors led by _____. This term sheet is intended solely as a basis for further discussion and is not intended to be and does not constitute a legally binding obligation.

PROPOSED TERMS FOR PREFERRED STOCK FINANCING OF (THE “COMPANY”)

Amount:	\$_____ at [First] Closing; [\$_____ at Second Closing prior to _____, 200__]	
Type of Security:	Series _____ Preferred Stock (“Preferred”)	
Price per Share:	\$_____ (“Original Purchase Price”)	
Investors:	_____ (collectively, the “Investors”)	
First Closing:	[First] Closing on or around _____, 200__	
Capitalization:	<u>Outstanding</u>	<u>Pro Forma</u>
Common Stock		
Preferred Stock		
Options		
Reserved		
Outstanding and unexercised		
Available for grant		
Warrants		
Convertible notes/other securities		

Comment: Dividends typically range from 7% to 10% of the Original Purchase Price. Most dividends are noncumulative.

Comment: This is a simple participating preferred, which means that the funds remaining after payment of the Preferred's Original Purchase Price will be shared equally by the Common and Preferred shareholders. As drafted, this provision is very favorable to investors because there is no cap on the amount they are to receive.

RIGHTS, PREFERENCES, PRIVILEGES, AND RESTRICTIONS OF PREFERRED

Dividends: Holders of Preferred shall be entitled to receive, prior to any payment of dividends to holders of the Common Stock of the Company (the "Common Stock"), annual dividends payable in the amount of \$_____ per share when and if declared by the Board of Directors. *[or, which shall cumulate from year to year annually on the anniversary date of the closing whether or not declared by the Board.]*

Liquidation Preference: 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 ("Liquidation Amount") equal to the Original Purchase Price *[or: plus all cumulated dividends]*. After payment of the Original Purchase Price *[or: plus all cumulated dividends]* to the holders of the Preferred, the remaining assets shall be distributed ratably to the holders of Common and Preferred on a common equivalent basis *[ratably to the holders of Common Stock] [or] [ratably to the holders of Common and Preferred on a common equivalent basis until the holders of Preferred have received a total return in the liquidation of three times the Original Purchase Price after which any remaining amounts will be distributed ratably to the holders of Common]*. A merger, acquisition, or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation.

Conversion

► **Optional:** The holders of the Preferred will have the right to convert their Preferred at their option, at any time, into shares of Common Stock. The total number of shares of Common Stock into which the Preferred may be converted initially will be determined by dividing the Original Purchase Price by the Conversion Price. The initial Conversion Price will be the Original Purchase Price. The Conversion Price will be subject to adjustment as provided in paragraph (iv) below.

Comment: *The purpose of forcing conversion is to clean up and simplify the Company's capitalization structure at the IPO. Company will want as much flexibility to force conversion (which generally means a 50% threshold), particularly if trying to do IPO in volatile markets when market conditions may cause the offering price to fall below the per-share price that will force conversion. May need to address majority threshold if representing investor that does not own a majority of the preferred. Alternatives include a supermajority threshold or a series vote.*

Comment: *Broad-based weighted average as shown is most typical and favorable to the Company. An alternative is a narrow-based weighted average formula which looks only at the outstanding stock (as opposed to all stock on a fully-diluted basis). Other, more rare, alternatives include a "ratchet" provision which is quite onerous from the Company's perspective as it provides that, upon a down round, the Conversion Price of the Preferred is adjusted downward to the issuance price of the dilutive financing. Another provision, the so-called "pay-to-play" provision, is burdensome to the investors because it requires that investors must participate in dilutive rounds to retain antidilution protection for their shares.*

► **Automatic Conversion:** All of the Preferred will be automatically converted into Common Stock, at the then-applicable Conversion Price, in the event that (x) holders of a majority of the Preferred consent to the conversion to Common Stock or (y) upon the closing of an underwritten public offering of shares of the Common Stock of the Company at a public offering price per share (prior to underwriting commissions and expenses) of not less than [2 to 5] times the Original Purchase Price in an offering of not less than \$20,000,000 (the "IPO").

Antidilution Protection: The Conversion Price of the Preferred will be subject to adjustment to prevent dilution in the event that the Company issues additional equity securities at a purchase price less than the applicable Conversion Price. [Ratchet alternative: The Conversion Price of the Series _____ Preferred will be subject to a "full ratchet" adjustment to reduce dilution in the event that the Company issues shares at less than the Conversion Price. The then-effective Conversion Price shall be reduced to the price paid for such newly issued shares.] The Conversion Price of the Preferred will be subject to adjustment on a broad-based weighted average basis. The Conversion Price shall not be adjusted because of (a) conversion of the Preferred, (b) securities issued to a commercial lender or lessor which is approved by the [entire] board, (c) the sale or grant of options to employees, directors, or consultants to purchase up to _____ shares of common stock [or the sale or grant of options to purchase shares approved [unanimously] by the Board of Directors], (d) issuances in acquisitions of another company or assets unanimously approved by the Board, and [(e) any other issuance that is approved by the [entire] Board.] The Conversion Price will also be subject to proportional adjustment for stock splits, stock dividends, recapitalizations, and the like.

Voting Rights:

Other than Directors. The holders of a share of Preferred will have a right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of Preferred.

Directors. The size of the board shall be set at _____. The holders of Preferred shall be entitled to elect _____ directors. The holders of Common shall be entitled to elect _____ directors. The remaining directors shall be elected by the Preferred and Common voting together.

Comment: *The Company will typically resist a redemption feature on the theory that the expected liquidity will be achieved when the Company goes public or is acquired. The investors may insist on the redemption feature to force the Company to cash them out at some point if the other liquidity options (an IPO or acquisition) have not occurred.*

Comment: *Need to consider threshold vote required: The Company will generally favor a simple majority threshold; however, if we represent the investors and the investors do not hold a majority of the outstanding preferred stock, may need consider a supermajority threshold or a series vote.*

[Redemption at Option of Investor: *At election of the holders of at least 50% of the Preferred, the Company shall redeem [1/3 of the Preferred on the fifth anniversary of the Closing, 1/3 on the sixth anniversary of the Closing and 1/3 on the seventh anniversary of the Closing], each at a redemption price equal to the Original Purchase Price [plus a rate of return equal to 10% per year on the Original Purchase Price [or: plus all cumulated dividends]] minus the amount of any dividends previously paid to holders of Preferred.]*

Protective Provisions: Consent of the holders of a [majority] of the outstanding Preferred Stock shall be required for: (i) any amendment or change of the rights, preferences, privileges, or powers of, or the restrictions provided for the benefit of, the Preferred; (ii) increases or decreases the authorized number of shares of Common or Preferred Stock; (iii) any action that authorizes, creates, or issues shares of any class of stock having preferences superior to or on parity with the Preferred; (iv) any action that reclassifies any outstanding shares into shares having preferences or priority as to dividends or assets senior to or on parity with the preference of the Preferred; (v) any amendment of the Company's Articles of Incorporation or Bylaws that adversely affects the rights of the Preferred; (vi) any merger or consolidation of the Company with one or more other corporations in which the shareholders of the Company immediately after such merger or consolidation hold stock representing less than a majority of the voting power of the outstanding stock of the surviving corporation; (vii) the sale of all or substantially all the Company's assets; (viii) the liquidation or dissolution of the Company; (ix) the declaration or payment of a dividend on the Common Stock (other than a dividend payable solely in shares of Common Stock);

[(x) the license by the Company of any of its technology of such a manner as to have the same economic effect as a sale or disposition of all or substantially all of the assets of the Company;] (xi) the repurchase by the Company of any shares of its capital stock, except redemption or repurchase of shares of common stock from employees or consultants upon termination of their employment or service pursuant to agreements providing for such repurchase; or (xii) changes the authorized size of the Company's Board [unless required during a future financing].

RIGHTS AGREEMENT

Registration Rights:

Comment: Generally, holders of 30% to 50% must demand registration.

Demand Rights: If, at any time that is six months after the Company's initial public offering [*or: If, at any time on or after two years from the Closing Date*], holders of at least [40%] 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 all or any portion of the Common Stock issued or issuable upon conversion of the Preferred, having an aggregate offering price to the public of not less than [\$5,000,000], the Company will use its best efforts to cause such shares to be registered, provided, however, that (a) the Company shall not be obligated to effect any such registration within 90 days prior to the filing of, and [90 to 180] days following the effective date of, a registration statement pertaining to an underwritten public offering of the Company's securities, (b) such registration obligation shall be deferred not more than six months from the date of receipt of request from the initiating holders if the Company furnishes the initiating holders with a certificate of the Chairman of the Board stating that in the good-faith judgment of the Board, it would be seriously detrimental to the Company and its shareholders for such registration statement to be effected at such time, provided that the right to delay a request may be exercised by the Company not more than once in any 12-month period, and (c) the Company shall not be obligated to effect more than [two] such demand registrations. Any such registration shall be firmly underwritten by an underwriter of nationally recognized standing.

Comment: Registrations on Form S-3 not possible until one year after IPO; shorter form, much less expensive. Typically, offering must be between \$1 million and \$5 million.

Comment: Limit underwriter “cutback” after IPO; typically 20-30%.

Comment: Founders may be given limited or subordinate rights. Important to define Founders who will have this right and who will be subject to Right of First Refusal and Co-Sale Agreement (see below).

Comment: Underwriter “lock-up” provisions are typically 180 days for IPOs. Some investors want no more than 90 days agreed to in advance to preserve ability to negotiate a shorter lockup period with underwriters. This may, however, create a burden later in getting numerous investors to agree to extend the period at the time of the IPO.

Comment: Condition “lockup” on agreement of officers, directors and holders of 1% or more of the Company’s securities being subject to same restrictions.

Registrations on Form S-3: Holders of at least 20% or more of the Preferred (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred) with proceeds of at least [\$5,000,000] will have the right to require the Company to file one registration statement annually on Form S-3 with respect to Common Stock issued upon conversion of the Preferred.

Piggyback Registration: The Investor [and _____, _____ and _____ (collectively, the “Founders”)] will be entitled to “piggyback” registration rights with respect to offerings registered by the Company, subject to the right of the Company and its underwriters, in view of market conditions, to reduce (but to no less than 30% of any offering after the IPO) the number of shares of the Investor [and Founders] proposed to be registered. [All shares proposed to be registered by the Founders shall be cut back prior to any reduction of the number of shares proposed to be registered by the Investor.]

Registration Expenses: The registration expenses (exclusive of underwriting discounts and commissions) of all demand registrations, Form S-3 registrations, and piggyback registrations will be borne by the Company.

Transfer of Registration Rights: The registration rights may be transferred to a transferee (other than a competitor of the Company) who acquires at least 10% of the Investor’s shares. Transfer of registration rights to a partner, affiliate, or related entity of the Investor will be without restrictions as to minimum shareholdings.

Other Registration Provisions: Other provisions will be contained in the Rights Agreement with respect to registration rights, including cross indemnification, the agreement by Investors if requested by the underwriter in a public offering not to sell any Common Stock that they hold for a period of 180 days following the effective date of the registration statement for the IPO or 90 days following a subsequently public offering (subject to all directors, officers, and holders of 1% or more of the Company’s securities entering into similar agreements), the period of time in which the registration statement will be kept effective, underwriting arrangements, and the like.

Comment: *If we represent the Company, we will want to be able to grant rights pari passu with the registration rights contained in the Rights Agreement. Investors should agree to this if the new rights holders are cut-back prior to any investor being cut-back.*

Comment: *Depending on composition of investors, may want a threshold other than a simple majority. Company will probably prefer a simple majority threshold.*

Comment: *The Company will want simpler termination language, such as, "upon any three-month period when the Investors can sell all of their shares pursuant to Rule 144."*

Comment: *Information rights and inspection rights should have the same percent threshold. Will want threshold high enough so that each small investor does not have these rights, but each primary investor does have these rights.*

Comment: *Sometimes information rights and inspection rights will terminate if an investor begins converting some of its preferred stock.*

Granting of Subsequent Registration Rights: The Company shall not grant registration rights to any third party that are superior to [or pari passu with] the registration rights set forth in the Rights Agreement without the prior written consent of holders of a [majority] of the Preferred.

Termination of Registration Rights: The registration obligations of the Company shall terminate five years after the initial public offering. In addition, the registration rights will terminate if (i) the Company has completed its IPO, (ii) an Investor (together with its affiliates, partners, and former partners) hold less than [1%] of the Company's outstanding Common Stock (treating all shares of convertible preferred stock on an as-converted basis) and (iii) all such stock held by an Investor (and its affiliates, partners, and former partners) may be sold under Rule 144 during any ninety (90)-day period.

Information Rights:

So long as an Investor holds not less than [5% to 15%] of the total Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred), the Company will deliver to the Investor audited annual and unaudited quarterly financial statements. So long as the Investor holds not less than ____% of the total Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred), the Company will timely furnish the Investor with budgets and monthly financial statements. These obligations of the Company will terminate upon a public offering of Common Stock [or at such time as an Investor has converted more than [50%] of its Preferred into Common Stock].

Inspection Rights:

The Company shall permit an Investor that holds not less than ____% of the total Preferred issued in the financing (or Common Stock issued upon conversion of the Preferred or a combination of such Common Stock and Preferred) to visit and inspect the properties of the Company, including its corporate and financial records, and to discuss its business and finances with officers of the Company during normal business hours following reasonable notice.

Right of First Refusal:

In the event the Company offers equity securities (other than (i) options reserved at the Closing under the Company's option plans, (ii) upon conversion of outstanding Preferred, (iii) upon exercise of outstanding options or warrants, (iv) in connection with an acquisition or a public offering that is approved by the [entire] board [, including the _____ director], or (v) in connection with an equipment lease or commercial lending arrangement that has been approved by the [entire] board [, including the _____ director], each Investor who holds not less than ____% of the total Preferred issued in the financing (or Common Stock issued upon conversion of Preferred or any combination of such Preferred and Common Stock) shall have a right of first refusal to purchase such portion of those equity securities as to maintain its pro-rata ownership interest in the Company. This right shall terminate upon the closing of an IPO or an acquisition of the Company [or at such time as an Investor has converted more than [50%] of its Preferred into Common Stock].

Miscellaneous Provision: Amendment/Waiver of Rights Agreement

No right may be waived and the Rights Agreement may not be amended without the approval of the Company and the holders of a [majority] of the Preferred.

Comment: Important to define the investors who will have this right (generally the same as the ones who have information and observation rights) and which issuances of equity securities will not trigger this right.

Comment: Sometimes investors will want right to subscribe for more than their pro-rata portion, including, in some rare cases, all of a future financing.

Comment: Depending on composition of the investors, may want to adjust threshold, though Company will prefer a majority threshold.

Comment: The percent of stock that Founders may transfer free of any restrictions ranges from 1% to 10%; generally, 5% is standard.

Comment: The release of Founder's shares from Company right of repurchase is highly negotiated at the time of first venture financing. Generally, the Founder will be given some credit for work done prior to financing so not all Founder's shares will be subject to right of repurchase. The Founder's remaining shares will be released from the repurchase option either monthly thereafter (which is typical) or some portion one year after the financing and then monthly thereafter.

RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT

Right of First Refusal: Except for gifts to a spouse or children, or transfers to the estate of a deceased shareholder, or transfers of up to [1% to 10%] of all of the Founder's stock (including all preferred and common stock), a Founder may not transfer any shares of the Company's capital stock now owned or hereafter acquired without first offering it to the Company and then to the Investors. [If an Investor does not exercise its pro-rata right, other Investors that exercise their right may purchase the non-participating Investor's portion.]

Put Right: In the event a Founder transfers his shares in violation of this Right of First Refusal and Co-Sale Agreement, the Investors shall have the right to put a pro-rata portion of their shares to such Founder.

FOUNDER STOCK-RESTRICTION AGREEMENT

Each Founder 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 stock held by such person in the event that such shareholder's employment with the Company is terminated, prior to the expiration of ____ months from the date of the Preferred Stock Purchase Agreement (the "Measuring Date"). A portion of the shares will be released from the repurchase option based upon continued employment by the Company as follows: [____% will be released from the repurchase option as of the date of the Preferred Stock Purchase Agreement; an additional ____% will be released from the repurchase option on the first anniversary of the Measuring Date, and an additional ____% will be released on the completion of each month thereafter.]

Comment: You will need to think through the representation and warranties. Generally, Investors want cleaner reps and warranties with fewer qualifiers (knowledge and materiality), while the Company will want fewer reps and warranties and more qualifiers.

Comment: Key-man insurance is good source of funds for redemption in early-stage company, if investors have requested the right of redemption.

Comment: Investor's counsel usually capped between \$10,000 and \$30,000.

OTHER AGREEMENTS AND CONDITIONS

The Preferred Stock Purchase Agreement: The purchases of the Preferred will be made pursuant to a Preferred Stock Purchase Agreement reasonably acceptable to the Company and the Investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein and appropriate conditions to closing which will include, among other things, qualification of the shares under applicable Blue Sky laws, the filing of Amended and Restated Articles of Incorporation, and receipt of an opinion of counsel. The Preferred Stock Purchase Agreement shall provide that it may only be amended and any waivers thereunder shall only be made with the approval of the holders of a majority of the Preferred.

Proprietary Information and Inventions Agreement: Each officer and employee of the Company will enter into a proprietary information and inventions agreement with the Company.

Key Man Insurance: [\$1,000,000] policy on the lives of each of the Founders, with the Company as beneficiary [but with proceeds to be applied to redemption of Preferred Stock at the election of holders of the majority of Preferred.]

Finders: The Company and the Investors shall each indemnify the other for any broker's or finder's fees for which either is responsible.

Expenses: The Company and the Investors will each bear their own legal and other expenses with respect to the transaction (except that, assuming a successful completion of the transaction, the Company will pay reasonable legal fees and expenses incurred by counsel to the Investors, up to \$_____).

Comment: If representing the Company, try to delete bracketed language re [in their sole discretion].

The Closing: The Closing of the purchase of the Preferred will be conditioned upon the following:

- ▶ Completion of due diligence to the satisfaction of the Investors [in their sole discretion];
- ▶ Compliance by the Company with applicable securities laws;
- ▶ Opinion of counsel to the Company rendered to the Investors in form and substance satisfactory to the Investors and their counsel;
- ▶ [Other material conditions];
- ▶ Such other conditions as are customary for transactions of this type.

CORPORATE INVESTORS

Comment: Should receive careful consideration when a corporate investor is investing.

Confidentiality [and Standstill]: Each corporate investor will enter into a confidentiality agreement covering standard information disclosed by the Company [and a standstill agreement for a period of five years] [and will enter into a voting agreement agreeing to vote all shares [in the event of a merger or acquisition of the Company or a sale of all assets] in the same manner as the majority of all other shareholders]. Further, to avoid conflicts of interest, any director [or observer] affiliated with such investor may be excluded from any portion of any Board meeting when the majority of the other Board members deems it to be appropriate to protect the interests of the other stockholders.

OTHER MATTERS

In consideration of the Investors' commitment of substantial resources to perform and complete a due-diligence review of the Company, the Company agrees that during the period between the acceptance of this Term Sheet and _____, 200____, the Company shall not enter into or continue discussions with any third party, either agent or principal, concerning a possible investment, public offering, merger, acquisition, or other business arrangement. If for any reason the Investors decide not to proceed with this investment, they will provide immediate written or verbal notice to management of the Company, and all terms, including the "exclusivity" outlined above, will terminate upon such notice.

This offer will expire if not accepted by _____.

Agreed and Accepted

[Company]

[Investors]

Date:_____

Date:_____

Counsel for the Company is:

Counsel for the Investors is: