WILLIAMS MULLEN VENTURE CAPITAL GUIDE

Your reference guide to venture capital basics

WILLIAMS MULLEN
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Williams Mullen is a different kind of law firm. Our attorneys are entrepreneurial, uniquely blending the law, government relations and economic development to help grow the business of our clients in the U.S. and worldwide.

Yes, we are an AmLaw 200 firm founded in 1909 with over 220 attorneys in 11 offices across North Carolina, South Carolina, Virginia and Washington, D.C. However we also know that bigger isn't always better. Our geographic focus makes us a part of our region and helps us leverage connections in business, governments and courts for clients. Meanwhile our industry experience in both established and high growth sectors allows us to practice law on a global scale.

Achieving such an extraordinary level of value requires having the right team of lawyers with the right attitude towards client service and client relationships. We call this ***Finding Yes®***. At Williams Mullen, we push ourselves every day to better understand each client and its business – and to figure out creative ways of helping each client achieve its business objectives. Quite simply, we are committed to finding better ways to make good things happen for our clients.

INTRODUCTION

INSIDE

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At Williams Mullen, our goal is not to be just lawyers to our clients – we strive to be partners who constantly add value to your business, especially when you are building it from the ground up. Sometimes adding value can be as simple as explaining the basics without fear that the meter always is running.

The Williams Mullen Venture Capital Guide provides a general guide to the way in which venture capital investments typically are structured and the unique vocabulary that is involved. However, every company and investment are unique, and the issues and terms involved in each situation may vary significantly. Therefore, this Venture Capital Guide is intended for informational purposes only and does not provide legal or business advice. We urge you to seek the counsel of an experienced business attorney and an accountant before negotiating the terms of a venture capital investment.

We push ourselves every day to think of new ways of ***Finding Yes®*** for our clients. When the time is right, we sincerely hope you will allow us to put that commitment to work for you.

Venture capital is a professionally managed pool of capital that is raised from public and private pension funds, endowments, foundations, banks, insurance companies, corporations, and wealthy families and individuals to form a venture fund.

Venture capitalists (VCs) and venture funds generally make investments in private, early-stage companies with high growth potential that may have difficulty obtaining traditional bank financing. An attractive prospective investment for a VC will have a viable exit scenario within five to seven years. Typical exit scenarios involve a sale or acquisition of the company by a larger company or an initial public offering. A VC may participate in more than one financing round where the company meets certain benchmarks over time. These subsequent rounds generally occur every few years.

A typical VC investment structure involves a cash investment in a company in exchange for equity in the company (usually convertible preferred stock) and will include rights and protections that are designed to allow the VCs to gain liquidity and maximize the return for their investors.

VC investment terms may seem onerous and complex to entrepreneurs. However, by understanding the goals of the VCs, entrepreneurs will be in a better position to negotiate an investment structure that meets the goals of both the VCs and management.

LIQUIDATION RIGHTS

Most venture capital investments are structured as convertible preferred stock with dividend and liquidation preferences. The preferred stock often will bear a fixed-rate dividend that, due to the cash constraints of early-stage companies, is not payable currently but is cumulative and becomes part of the liquidation preference upon a sale or liquidation of the company. The payment of dividends on the preferred stock will have priority over common stock dividends. These cumulative dividend rights provide a priority minimum rate of return to the VCs.

The preferred stock will have a liquidation preference that generally is equal to the original purchase price paid by the VC for the preferred stock (or a multiple thereof), plus accrued and unpaid dividends, to ensure that the VCs get their money back before the holders of the common stock (e.g., founders, management, and employees) receive any proceeds in the event that the company is sold or liquidated. Most VCs also insist on participation rights so that they share on an equal basis with the holders of the common stock in any proceeds that remain after the payment of their liquidation preference. These liquidation rights and the right to convert the preferred stock into common stock allow the VCs to share in the upside if the company is successfully sold.

OWNERSHIP PROTECTION

An important consideration to VCs is the percentage of the company that they own on a fully-diluted basis. Fully-diluted means the total number of issued shares of common stock, plus all shares of common stock that would be issued if all outstanding options, warrants, convertible preferred stock, and convertible debt were exercised or converted. This percentage is a function of the pre-money valuation of the company upon which the VCs and the company agree. In determining the pre-money valuation, VCs analyze the projected value of the company and the percentage of this value that will provide them with their required rate of return. This analysis takes into account the risks to the company and the future dilution of the initial investors from anticipated follow-on investments. VCs protect their ownership percentages through preemptive rights, anti-dilution protection, and price protection. Preemptive rights enable the investors to maintain their percentage ownership in the company by purchasing a pro rata share of stock sold in future financing rounds. Anti-dilution protection adjusts the investors' ownership percentages if the company effects a stock split, stock dividend, or recapitalization. Price protection adjusts the conversion price at which the preferred stock can be converted into common stock if the company issues common stock or other securities that are convertible into common stock at a price below the current conversion price of the preferred stock (i.e., the VCs will be issued more shares of common stock upon the conversion of their preferred stock). This protects the VCs from the risk that they overpaid for their stock if the pre-money valuation turns out to be too high.

There are two common types of price protection: full ratchet and weighted average ratchet. A full ratchet adjusts the conversion price to the lowest price at which the company subsequently sells its stock, regardless of the number of shares of stock the company issues at that price. A weighted average ratchet adjusts the conversion price according to a formula that takes into account the lower issue price and the number of shares that the company issues at that price.

MANAGEMENT PARTICIPATION AND CONTROL

Many VCs state that they invest in management, not technology, and VCs expect the management team to operate the business without undue interference. However, most investment structures provide that the VCs participate in management through representation on the board of directors, affirmative and negative covenants or protective provisions, and stock transfer restrictions. Typical protective provisions give the VCs the right to approve amendments to the company's Certificate of Incorporation and Bylaws, future issuances of stock, the declaration and payment of dividends, increases in the company's stock option pool, expenditures in excess of approved budgets, the incurrence of debt, and the sale of the company. In addition, VCs generally require that management's stock be subject to vesting and buy-back rights.

As long as the company is achieving its business goals and not violating any of the protective provisions, most VCs permit management to operate the business without substantial investor participation except at the board level. However, VCs may negotiate the right to take control of the board of directors if the company materially fails to achieve its business plan or to meet certain milestones, or if the company violates any of the protective provisions.

EXIT RIGHTS

VCs must achieve liquidity in order to provide the requisite rate of return to their investors. Most VC funds have a limited life of 10 years, and most investments from a fund are made in the first four years. As a result, investments are structured to provide liquidity within five to seven years so that investments that are made in a fund's third and fourth years are liquidated as the fund winds up and its assets are distributed to the fund's investors. The primary liquidity events for VCs are the sale of the company, the initial public offering of the company's stock, or the redemption or repurchase of their stock by the company.

Generally, VCs do not have a contractual right to force the company to be sold. However, the sale of the company will be subject to the approval of the VCs, and depending upon the composition of the board of directors, the VCs may be in a position to direct the sale efforts. VCs typically also have demand registration rights that theoretically give them the right to force the company to go public and register their shares. Also, VCs generally will have piggyback registration rights that give them the right to include their stock in future company registrations after the company's stock is publicly-traded.

VCs also insist on redemption (or "put") rights to achieve liquidity if it is not available through a sale or public offering. This gives the investors the right to require the company to repurchase their stock after a period of generally four to seven years. The purchase price for the VCs' stock may be based upon the liquidation preference (i.e., the purchase price, plus accrued and unpaid dividends), the fair market value of the stock as determined by an appraiser, the value of the stock based upon a multiple of the company's earnings, or another mutually negotiated and agreed method specified in the investment documents. An early-stage company (particularly one that is struggling) may not be able to finance the buyout of an investor, and the redemption rights may not be a practical way to gain liquidity. However, these rights give the VCs tremendous leverage to force management to deal with their need for an exit and can result in a forced sale of the company. Also, if the VCs trigger their redemption rights and the company breaches its payment obligations, the VCs may be able to take control of the board of directors of the company.

Other exit rights that VCs often require are "tag along" and "drag along" rights. Tag-along rights give the investors the right to include their stock in any sale of stock by management. Drag-along rights give the investors the right to force management to sell their stock in any sale of stock by the investors.

GLOSSARY OF FREQUENTLY USED TERMS

BASIC EQUITY TERMS

Authorized Shares: The total number of shares of capital stock that a company is authorized to issue in its Certificate of Incorporation.

Capitalization Chart: A spreadsheet or table that shows the ownership, on a particular date, of a company's issued and outstanding shares of capital stock and other securities that are convertible into or exercisable for shares of capital stock (such as Options, Warrants, Convertible Stock, and convertible debt).

Common Stock: Common Stock is the basic ownership interest in a company. Common stockholders have voting rights, dividend rights, and liquidation rights that are proportionate to the number of shares that they own. The liquidation rights of the holders of Common Stock are subordinate to those of the company's secured and unsecured creditors as well as to the holders of the company's Preferred Stock. The dividend rights of the company's Common Stock may be subject to the Dividend Preference of the company's Preferred Stock.

Convertible Stock: Convertible Stock is stock (generally Preferred Stock) that is convertible into another type of stock (generally Common Stock) at a predetermined Conversion Price or Conversion Ratio.

Founders: The Founders are the individuals who start or found a company and hold Founders' Stock. For a more in depth discussion of the issues encountered by Founders when launching a new company, see our companion Founder's Handbook which is available upon request.

Founders' Stock: Founders' Stock refers to the shares of Common Stock that are issued to the Founders of a company upon its initial organization and is generally based on their relative contributions to the creation of the company. The Founders' Stock may be subject to a Stock Restriction Agreement that provides for vesting of the Founders' Stock over time.

Fully-Diluted Shares: A company's Fully-Diluted Shares refers to the total number of shares of Common Stock that the company has issued; plus all shares of Common Stock that would be issued if all outstanding Options, Warrants, Convertible Stock, and convertible debt were exercised or converted; plus all shares of Common Stock that are reserved under the Option Pool.

Issued and Outstanding Shares: A company's issued and outstanding shares refers to the total number of shares of stock that the company has actually issued to stockholders on a particular date.

Option Pool: The Option Pool refers to the total number of shares of stock (generally Common Stock) that a company has reserved for issuance to employees, directors, and advisors under its stock option plan. The size of the Option Pool will depend on the number of shares that the company and the investors determine to be necessary to hire the employees that the company will need to execute its business plan.

Options: Options are securities that permit the holder to purchase a specified number of shares of the company's stock (generally Common Stock) at a predetermined price (the exercise price) and for a certain period of time. Generally, the right to purchase the shares vests, and the Option becomes exercisable, over a period of time.

Preferred Stock: Preferred Stock is a class of stock that has rights and preferences that are superior to those of the company's Common Stock. Generally, these rights and preferences include Affirmative Covenants, Anti-Dilution Protection, Conversion Rights, Co-Sale Rights, Dividend Preference, Drag-Along Rights, Liquidation Preference, Preemptive Rights, Price Protection, Protective Provisions or Negative Covenants, Redemption Rights or Put Rights, Registration Rights, and Rights of First Refusal. Preferred Stock is designated by Series such as Series A, Series B, and so forth.

Stock Restriction Agreement: A Stock Restriction Agreement gives the company the right to purchase a decreasing number of the shares of Common Stock owned by a Founder over a period of generally three to four years if the Founder's employment with the company is terminated.

Generally, the repurchase price of the shares is the same price that the Founder paid for the shares. Under a Stock Restriction Agreement, a Founder's shares will vest as the company's repurchase rights lapse over the term of the agreement. Even though the unvested shares are subject to the company's repurchase rights, the Founder has full voting and other rights with respect to all of the shares.

Warrants: Warrants are securities that permit the holder to purchase a specific number of shares of the company's capital stock at a predetermined price (the exercise price) and for a certain period of time. Generally, a company will issue Warrants to investors, lenders, or strategic partners as an "equity sweetener" to enhance the underlying investment, credit facility, or other business arrangement.

VENTURE CAPITAL TERMS

Affirmative Covenants: Affirmative Covenants require a company to provide certain information to its investors on a regular basis or to take or maintain certain corporate actions. Typical Affirmative Covenants give the investors the right to receive monthly, quarterly, and annual financial statements and annual budgets, or require the company to maintain certain insurance (including key-man life insurance on the Founders) or to maintain the size and composition of the company's board of directors.

Anti-Dilution Protection: Anti-Dilution Protection adjusts the investors' ownership percentages if the company effects a stock split, stock dividend, or recapitalization.

Board Observation Rights or Board Visitation Rights: Major investors in a company will require the right to one or more seats on the company's board of directors. Other investors in the company may require the right to have a representative attend meetings of a company's board of directors as a non-voting observer.

Carried Interest: The Carried Interest is the share of a venture fund's profits that the General Partner is entitled to receive. Often, the General Partner will not receive the Carried Interest until the venture fund achieves profits above a specified rate of return. The Carried Interest also is referred to as "carry" or a "performance fee."

Conversion Price or Conversion Ratio: The Conversion Price or the Conversion Ratio determines the number of shares of Common Stock into which each share of Preferred Stock is convertible and is adjusted based on the investors' Anti-Dilution Protection and Price Protection.

Conversion Rights: Investors generally have the right to convert their shares of Preferred Stock into shares of Common Stock at any time at the applicable Conversion Price or Conversion Ratio.

Co-Sale Rights: Co-Sale Rights give the investors the right to sell all or a portion of their shares as a condition to the Founders of the company selling any of their shares. This protects the investors from being locked into an investment if the Founders have sold their shares.

Cram Down Round: Generally, a Cram Down Round is a Down Round in which the new investors require the previous round investors to waive all or a portion of their Price Protection. A Cram Down Round also may be effected by the new investors requiring the previous round investors to convert their shares of Preferred Stock into shares of Common Stock or by recapitalizing the previous round investors' shares of Preferred Stock into a lesser number of shares. In a Cram Down Round, the equity interests of the previous round investors are diluted, and the new investors own a greater equity interest in the company.

Cumulative Dividends: Cumulative Dividends mean that if the dividend is not declared during the applicable time period, it accrues and is payable at a later time.

Dilution: Dilution refers to a decrease in the percentage ownership of a stockholder as a result of the issuance by the company of additional equity securities.

Dividend Preference: The payment of dividends on the Preferred Stock that a company issues to its investors will have priority over Common Stock dividends. Generally, the investment documents will provide that the company cannot pay any dividends on the Common Stock unless the company pays equivalent dividends on the Preferred Stock. Often, the Preferred Stock will bear a fixed dividend rate, and, due to the cash constraints of early-stage companies, the dividends will not be payable currently but will accrue and become part of the Liquidation Preference that is payable upon the Liquidation of the company.

Down Round: A Down Round is a financing in which the Pre-Money Valuation of the company is less than the Post-Money Valuation of the company in its previous round of financing. A Down Round will trigger the Price Protection of the investors in the previous rounds of financing.

Drag Along Rights: Drag Along Rights give the investors the right to require the founders of the company (and possibly other key stockholders) to sell their shares if the investors decide to sell their shares. Generally, the buyer of the company wants to ensure that it will be able to purchase all the stock of the company. Drag Along Rights protect the investors by preventing the founders (and possibly other key stockholders) from blocking a sale of the company that the investors desire.

Due Diligence Review: The Due Diligence Review refers to the comprehensive risk analysis by a potential investor of a possible investment in a company. Among other things, the potential investor will evaluate the company's technology, products, business strategy, potential markets, management, corporate and legal documents and affairs, intellectual property, and accounting and financial matters.

Exit Strategy: A company's Exit Strategy is the method by which it intends to achieve a return for its investors, founders, and employee option holders. The most common exit strategies are the sale of the company or an Initial Public Offering.

Full Ratchet: A Full Ratchet is a form of Price Protection that adjusts the Conversion Price to the lowest price at which the company subsequently sells shares of its stock, regardless of the number of shares that the company sells at that price.

General Partner: If the venture fund is structured as a limited partnership, the General Partner generally is the VC firm.

Limited Partner: If the venture fund is structured as a limited partnership, the Limited Partners generally are the investors in the venture fund.

Liquidation: A Liquidation typically means the sale of the company, whether through a sale of the voting control of its stock, a merger, or a sale of all or substantially all of its assets. A Liquidation also includes the voluntary or involuntary dissolution of the company where the company winds down its operations or goes out of business.

Liquidation Preference: Upon the Liquidation of a company, the holders of the company's Preferred Stock have the right to receive distributions of money or assets prior to any class of subordinate stock (such as Common Stock). The Liquidation Preference generally is equal to the purchase price of the Preferred Stock (or a multiple thereof), plus accrued but unpaid dividends. The Liquidation Preference ensures that the investors get their investment back, plus a fixed return, before the founders, management, and employees receive any proceeds of the Liquidation.

Mandatory Conversion: Upon the closing of a Qualified Initial Public Offering, the investors are required to convert their shares of Preferred Stock into shares of Common Stock at the applicable Conversion Price or Conversion Ratio.

Pari Passu: Upon a Liquidation, the Liquidation Preferences generally are paid to the investors in the reverse order of that in which their investments were made. That is, the last investors get paid their Liquidation Preferences first. However, some investors require that the Liquidation Preferences be paid to the investors Pari Passu, meaning at the same time or at the same level and without regard to the order in which the investments were made. If the proceeds of the Liquidation are insufficient to pay all of the Liquidation Preferences, then the investors generally divide the proceeds on a pro rata basis.

Participating Preferred Stock or Participation Rights: Participation Rights mean that the investors share on a pro rata basis with the holders of Common Stock in any proceeds of the Liquidation that remain after the payment of their Liquidation Preference. If the investors do not have Participation Rights, they must choose either to receive their Liquidation Preference or convert their shares of Preferred Stock into Common Stock and participate on a pro rata basis with the holders of Common Stock in the Liquidation proceeds.

Pay-to-Play Provisions: Pay-to-Play Provisions provide that, if an investor does not participate in a company's subsequent financing rounds, then the non-participating investor will lose its Anti-Dilution Protection, Price Protection, or Preemptive Rights. Even more onerous Pay-to-Play Provisions provide that the non-participating investor will forfeit its shares of Preferred Stock for a de minimis amount or that its shares of Preferred Stock are converted to shares of Common Stock. These provisions are intended to keep the investment syndicate in place to continue to fund the company by being punitive to non-participating investors.

Post-Money Valuation: The Post-Money Valuation is the value of the company immediately after the investment. It is determined by adding the amount that is invested in the financing to the Pre-Money Valuation of the company. For example, if the Pre-Money Valuation of the company is $3,000,000, and the investors invest $1,000,000 in the financing, then the Post-Money Valuation of the company is $4,000,000.

Pre-Money Valuation: The Pre-Money Valuation is the value of the company immediately prior to the investment that is agreed upon by the company and the investors. It generally is expressed as a total dollar amount, such as $3,000,000. However, it may also be expressed as a price per share, such as $1 per share. If the Pre-Money Valuation of the company is $3,000,000 and the company has 3,000,000 Fully Diluted Shares prior to the investment, then the price that the investors will pay in the financing is $1 per share. If the investors invest $1,000,000, the company will issue 1,000,000 shares to the investors, and the investors will own 25% of the company (i.e., the investors will own 1,000,000 shares out of a total of 4,000,000 shares).

Preemptive Rights: Preemptive Rights give the previous round investors the right to purchase a pro-rata portion of the shares of stock issued by the Company in future financing rounds on the same terms and conditions as the investors in such future financing rounds.

Price Protection: Price Protection adjusts the Conversion Price if a company issues Common Stock or other securities that are convertible into or exercisable for Common Stock at a price per share below the current Conversion Price. The result is that the investors will be issued more shares of Common Stock upon the conversion of their Preferred Stock. This protects the investors from the risk that they overpaid for their stock if the Pre-Money Valuation turns out to be too high. The typical formulas for determining the amount of Price Protection are Full Ratchet and Weighted Average Ratchet.

Protective Provisions or Negative Covenants: Protective Provisions or Negative Covenants give the investors the right to approve certain corporate actions. Typical Protective Provisions give the investors the right to approve amendments to the company's Certificate of Incorporation and Bylaws, future issuances of stock, the declaration and payment of dividends, increases in the company's Option Pool, expenditures in excess of approved budgets, the incurrence of debt, the sale of the company, and changes in the company's line of business.

Redemption Rights or Put Rights: Redemption Rights or Put Rights give the investors the right to require the company to repurchase the investors' stock after a period of generally four to seven years. The repurchase price for the stock may be based upon the amount of the Liquidation Preference, the fair market value of the stock as determined by an appraiser, or the value of the stock based upon a multiple of the company's earnings.

Rights of First Refusal: The investors generally require the Founders of the company to agree that if they ever desire to sell all or a portion of their stock, the Founders must first offer to sell the stock back to the company and then to the investors. Rights of First Refusal protect the investors and the non-selling Founders from a sale of the stock to an unfriendly party.

Term Sheet: A non-binding summary of the major terms and conditions of a proposed investment in a company by the investors. A Term Sheet may have a binding exclusivity or no-shop provision whereby the company and the Founders agree that they will not initiate or hold discussions with other potential investors for some period of time after the Term Sheet is signed. Also, some investors require the company to pay their legal fees and due diligence expenses even if the investment set forth in the Term Sheet does not close for any reason.

The National Venture Capital Association's (the "NCVA") model Term Sheet for Series A Preferred Stock Financing (the "NCVA Model Term Sheet") is reprinted in the next section of this Venture Capital Guide. The NCVA Model Term Sheet and other related model investment documents are available in, and may be downloaded free of charge from, the Resources Section of the NCVA's website: ncva.org.

Weighted Average Ratchet: A Weighted Average Ratchet is a form of Price Protection that adjusts the Conversion Price according to a formula that takes into account the lower issue price and the number of shares that the company issues at that price. In other words, the larger the number of dilutive shares that the company issues, the greater the adjustment to the Conversion Price.

SECURITIES LAW TERMS

Accredited Investor: Under Rule 501 of Regulation D of the Securities Act, an individual is deemed to be an Accredited Investor if the individual's net worth or joint net worth with his or her spouse exceeds $1,000,000 (excluding the value of his/her/their primary residence) or if the individual had income in excess of $200,000 in each of the two most recent years or joint income with his or her spouse in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same level of income in the current year. Directors and executive officers of the company and entities with assets in excess of $5,000,000 that are not formed for the specific purpose of acquiring securities also are considered Accredited Investors.

Best Efforts Underwriting: In a Best Efforts Underwriting, the Underwriter is obligated only to use its reasonable best efforts to sell the stock that is being offered by the company in a public offering. The Underwriter has the right to return any unsold shares to the company.

Blue Sky Laws: Blue Sky Laws are state laws that regulate the issuance of securities. All issuances and transfers of securities must comply with both the federal securities laws and the Blue Sky Laws of the state in which the securities are being offered and sold.

Demand Registration Rights: Demand Registration Rights are a type of Registration Rights that give the investors the right to require the company to file a Registration Statement with respect to their shares. Typically, the investors cannot exercise their Demand Registration Rights until after the company is public. However, absent this restriction, the investors could exercise their Demand Registration Rights and require the company to conduct an Initial Public Offering.

Exchange Act: The Exchange Act refers to the Securities Exchange Act of 1934. The Exchange Act provides for the filing of various periodic reports with the SEC by public companies, the regulation of proxy solicitations, and limitations on insider trading. Also, the Exchange Act governs the operations of stock exchanges and over-the-counter trading.

Federal Exemptions From Registration; Section 4(2); and Regulation D: When a company makes an offer to sell its securities (including shares of stock, Options, Warrants, and convertible debt), the company must either register the securities with the SEC pursuant to a Registration Statement filed under the Securities Act or issue the securities pursuant to an exemption from the registration requirements of the Securities Act. The most common exemption from registration is Section 4(2) of the Securities Act, which exempts from the registration requirements "transactions by an issuer not involving any public offering" (i.e., private placements). Securities that are issued in a private placement are referred to as "restricted securities," and they cannot be resold unless they are registered under the Securities Act or are resold pursuant to an exemption from registration. Regulation D, promulgated by the SEC, provides several "safe harbors" under Section 4(2) of the Securities Act if the offering meets certain criteria specified in Regulation D.

Firm Commitment Underwriting: In a Firm Commitment Underwriting, the Underwriter agrees to buy all of the shares that are offered by the company in a public offering at a fixed price and then resells those shares to the public at the higher offering price. Before signing the underwriting agreement for a Firm Commitment Underwriting, the Underwriter contacts investors and solicits "indications of interest," which are non-binding obligations of the investors to purchase the shares from the Underwriter. The Underwriter will not sign the underwriting agreement until it has accumulated "indications of interest" for at least the number of shares of stock that are being offered by the company. The Underwriter cannot return any unsold shares to the company.

Initial Public Offering (IPO): An Initial Public Offering is a company's first sale of shares of its Common Stock to the public. The company accomplishes an Initial Public Offering by filing a Registration Statement (generally on Form S-1) with the SEC. Most Initial Public Offerings are Firm Commitment Underwritings.

Market Stand-Off Agreement and Lock-Up Period: In connection with a public offering of stock, the Underwriters typically insist that certain stockholders of the company agree not to sell their shares of the company for some period of time (usually 180 days, and which is referred to as the Lock-Up Period) after the company's public offering. A Market Stand-Off Agreement is the agreement that the Underwriters require those stockholders to sign agreeing to this restriction.

Piggyback Registration Rights: Piggyback Registration Rights are a type of Registration Rights that give the investors the right to have shares that are owned by them included in a Registration Statement that the company files for itself or for a selling stockholder. Generally, Piggyback Registration Rights are not applicable to the company's Initial Public Offering.

Prospectus: A Prospectus is a document that summarizes an issuer's Registration Statement. The issuer must give a Prospectus to all potential purchasers of the company's securities in the offering. An issuer's preliminary Prospectus is called a "red herring" because it contains red legends on the front cover.

Qualified Initial Public Offering: A Qualified Initial Public Offering is an Initial Public Offering that raises gross proceeds for the company of a size and at a price per share that are agreed upon by the company and the investors. A Qualified Initial Public Offering will trigger the Mandatory Conversion of the Preferred Stock into Common Stock. The raising of gross proceeds for the company of at least $20,000,000 to $30,000,000 and at a price per share of at least three to five times the price per share that the investors paid are typical requirements for a Qualified Initial Public Offering.

Registration Rights: Registration Rights give the investors the right to require that the company include shares of Common Stock that are owned by the investors in the company's Registration Statements that are filed with the SEC.

Registration Statement: A Registration Statement is a disclosure document that a company (known as the issuer) files with the SEC pursuant to Section 5 of the Securities Act in order to register its shares of stock so that they can be sold to the public and become freely tradeable. It contains a description of the issuer's business and financial condition and of how the proceeds of the offering will be used. It also includes background information on the issuer's executive officers and directors, information on the issuer's capitalization, and audited financial statements.

SEC: The United States Securities and Exchange Commission, or SEC, is an independent, quasi-judicial federal agency that administers the federal securities laws, including the Securities Act and the Exchange Act.

Securities Act: The Securities Act refers to the Securities Act of 1933 that was intended to protect investors by ensuring that persons offering to sell stock provided accurate and complete information about the stock being sold. The Securities Act requires the registration of securities or the sale of securities pursuant to an exemption from registration and the disclosure of all material information regarding the issuer and the securities being sold, so that investors may make informed investment decisions.

Underwriter: An Underwriter is an investment banker that facilitates the sale of shares that are offered in a public offering. An Underwriter buys the stock from the company and resells it to investors. The Underwriter makes a profit on the spread between the price at which it buys the stock from the company and the price at which it resells the stock to investors.

This sample document is the work product of a national coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample document presents an array of (often mutually exclusive) options with respect to particular deal provisions.

Preliminary Note

This term sheet maps to the NCVA Model Documents, and for convenience the provisions are grouped according to the particular Model document in which they may be found. Although this term sheet is perhaps somewhat longer than a "typical" VC Term Sheet, the aim is to provide a level of detail that makes the term sheet useful as both a road map for the document drafters and as a reference source for the business people to quickly find deal terms without the necessity of having to consult the legal documents (assuming of course there have been no changes to the material deal terms prior to execution of the final documents).

SERIES A PREFERRED STOCK FINANCING OF
[INSERT COMPANY NAME], INC.
[__, 20__]

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [___________], Inc., a [Delaware] corporation (the "Company"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality [and Counsel and Expenses] provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors. This Term Sheet shall be governed in all respects by the laws of [______________the].[1]

OFFERING TERMS	
Closing Date:	As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the "Closing"). [provide for multiple closings if applicable]
Investors:	Investor No. 1: [__________] shares ([__]%), $[__________] Investor No. 2: [__________] shares ([__]%), $[__________] [as well other investors mutually agreed upon by Investors and the Company]
Amount Raised:	$[__________], [including $[__________] from the conversion of principal [and interest] on bridge notes].[2]
Price Per Share:	$[__________] per share (based on the capitalization of the Company set forth below) (the "Original Purchase Price").
Pre-Money Valuation:	The Original Purchase Price is based upon a fully-diluted pre-money valuation of $[_____] and a fully-diluted post-money valuation of $[_____] (including an employee pool representing [__]% of the fully-diluted post-money capitalization).
Capitalization:	The Company's capital structure before and after the Closing is set forth on Exhibit A.

CHARTER[3]	
Dividends:	[Alternative 1: Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock] [Alternative 2: The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.][4] [Alternative 3: Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[__________] per share of Series A Preferred when and if declared by the Board.]

CHARTER[3]	
Liquidation Preference:	In the event of any liquidation, dissolution or winding up ofCompany, the proceeds shall be paid as follows: [Alternative 1 (non-participating Preferred Stock): First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock.] [Alternative 2 (full participating Preferred Stock): First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis.] [Alternative 3 (cap on Preferred Stock participation rights): First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).] A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "Deemed Liquidation Event"), thereby triggering payment of the liquidation preferences described above [unless the holders of [__]% of the Series A Preferred elect otherwise]. [The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to escrow in connection with a Deemed Liquidation Event.][5]
Voting Rights:	The Series A Preferred shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) [so long as [insert fixed number, or %, or "any"] shares of Series A Preferred are outstanding,] the Series A Preferred as a class shall be entitled to elect [_________] [(_)] members of the Board (the "Series A Directors"), and (ii) as required by law. The Company's Certificate of Incorporation will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock.[6]

CHARTER[3]	
Protective Provisions:	[So long as [insert fixed number, or %, or "any"] shares of Series A Preferred are outstanding,] in addition to any other vote or approval required under the Company's Charter or Bylaws, the Company will not, without the written consent of the holders of at least [__]% of the Company's Series A Preferred, either directly or by amendment, merger, consolidation, or otherwise: (i) liquidate, dissolve or wind-up the affairs of the Company, or effect any merger or consolidation or any other Deemed Liquidation Event; (ii) amend, alter, or repeal any provision of the Certificate of Incorporation or Bylaws [in a manner adverse to the Series A Preferred];[7] (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences or privileges senior to or on parity with the Series A Preferred, or increase the authorized number of shares of Series A Preferred; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, [other than stock repurchased from former employees or consultants in connection with the cessation of their employment/services, at the lower of fair market value or cost;] [other than as approved by the Board, including the approval of [_________] Series A Director(s)]; or (v) create or authorize the creation of any debt security [if the Company's aggregate indebtedness would exceed $[_____][other than equipment leases or bank lines of credit][unless such debt security has received the prior approval of the Board of Directors, including the approval of [_________] Series A Director(s)]; (vi) create or hold capital stock in any subsidiary that is not a wholly-owned subsidiary or dispose of any subsidiary stock or all or substantially all of any subsidiary assets; [or (vii) increase or decrease the size of the Board of Directors].[8]
Optional Conversion:	The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under "Anti-dilution Provisions."

<table>
<tr><th>CHARTER[3]</th><th></th></tr>
<tr><td>Anti-dilution Provisions:</td><td>In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

[Alternative 1: "Typical" weighted average:

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

CP_2 = Series A Conversion Price in effect immediately after new issue
CP_1 = Series A Conversion Price in effect immediately prior to new issue
A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)[9]
B = Aggregate consideration received by the Corporation with respect to the new issue divided by CP_1
C = Number of shares of stock issued in the subject transaction]

[Alternative 2: Full-ratchet – the conversion price will be reduced to the price at which the new shares are issued.]

[Alternative 3: No price-based anti-dilution protection.]

The following issuances shall not trigger anti-dilution adjustment:[10]

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

CHARTER[3]	
Mandatory Conversion:	Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a [firm commitment] underwritten public offering with a price of [_____] times the Original Purchase Price (subject to adjustments for stock dividends, splits, combinations and similar events) and [net/gross] proceeds to the Company of not less than $[_________] (a "QPO"), or (ii) upon the written consent of the holders of [__]% of the Series A Preferred.[11]
[Pay-to-Play:	[Unless the holders of [__]% of the Series A elect otherwise,] on any subsequent [down] round all [Major] Investors are required to purchase their pro rata share of the securities set aside by the Board for purchase by the [Major] Investors. All shares of Series A Preferred[12] of any [Major] Investor failing to do so will automatically [lose anti-dilution rights] [lose right to participate in future rounds] [convert to Common Stock and lose the right to a Board seat if applicable].][13]
Redemption Rights:[14]	Unless prohibited by Delaware law governing distributions to stockholders, the Series A Preferred shall be redeemable at the option of holders of at least [__]% of the Series A Preferred commencing any time after [_________] at a price equal to the Original Purchase Price [plus all accrued but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)].[15]

STOCK PURCHASE AGREEMENT	
Representations and Warranties:	Standard representations and warranties by the Company. [Representations and warranties by Founders regarding technology ownership, etc.].[16]
Conditions to Closing:	Standard conditions to Closing, which shall include, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, and an opinion of counsel to the Company.
Counsel and Expenses:	[Investor/Company] counsel to draft Closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed $[______])and expenses of Investor counsel[, unless the transaction is not completed because the Investors withdraw their commitment without cause].[17] Company Counsel: [ ] Investor Counsel: [ ]

INVESTORS' RIGHTS AGREEMENT	
Registration Rights:	**Registrable Securities:** All shares of Common Stock issuable upon conversion of the Series A Preferred [and [any other Common Stock held by the Investors] will be deemed "Registrable Securities."[18]
	Demand Registration: Upon earliest of (i) [three-five] years after the Closing; or (ii) [six] months[19] following an initial public offering ("IPO"), persons holding [__]% of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than $[5-15] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered, and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).

INVESTORS' RIGHTS AGREEMENT	
Registration Rights:	**Registration on Form S-3:** The holders of [10-30]% of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate offering price of at least $[1-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [two] per year. **Piggyback Registration:** The holders of Registrable Securities will be entitled to "piggyback" registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [20-30]% on a pro rata basis and to complete reduction on an IPO at the underwriter's discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders' shares are reduced. **Expenses:** The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions will be borne by the Company. The Company will also pay the reasonable fees and expenses[, not to exceed $______,] of one special counsel to represent all the participating stockholders. **Lock-up:** Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company [(including/excluding shares acquired in or following the IPO)] for a period of up to 180 days [plus up to an additional 18 days to the extent necessary to comply with applicable regulatory requirements][20] following the IPO (provided all directors and officers of the Company [and [1 – 5]% stockholders] agree to the same lock-up). [Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to Investors, pro rata, based on the number of shares held. **Termination:** Upon a Deemed Liquidation Event, [and/or] when all shares of an Investor are eligible to be sold without restriction under Rule 144 [and/or] the [______] anniversary of the IPO. No future registration rights may be granted without consent of the holders of a [majority] of the Registrable Securities unless subordinate to the Investor's rights.

INVESTORS' RIGHTS AGREEMENT	
Management and Information Rights:	A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.[21] Any [Major] Investor [(who is not a competitor)] will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such Major Investor (i) annual, quarterly, [and monthly] financial statements, and other information as determined by the Board; (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year[; and (iii) promptly following the end of each quarter an up-to-date capitalization table. A "Major Investor" means any Investor who purchases at least $[______] of Series A Preferred.
Right to Participate Pro Rata in Future Rounds:	All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet. In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

INVESTORS' RIGHTS AGREEMENT	
Matters Requiring Investor Director Approval:	[So long as the holders of Series A Preferred are entitled to elect a Series A Director, the Company will not, without Board approval, which approval must include the affirmative vote of [one/both] of the Series A Director(s): (i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company; (ii) make any loan or advance to any person, including, any employee or director, except advances and similar expenditures in the ordinary course of business or under the terms of a employee stock or option plan approved by the Board of Directors; (iii) guarantee, any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business; (iv) make any investment inconsistent with any investment policy approved by the Board; (v) incur any aggregate indebtedness in excess of $[______] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business; (vi) enter into or be a party to any transaction with any director, officer or employee of the Company or any "associate" (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such person [except transactions resulting in payments to or by the Company in an amount less than $[60,000] per year], [or transactions made in the ordinary course of business and pursuant to reasonable requirements of the Company's business and upon fair and reasonable terms that are approved by a majority of the Board of Directors];[22] (vii) hire, fire, or change the compensation of the executive officers, including approving any option grants; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; (ix) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (x) enter into any corporate strategic relationship involving the payment contribution or assignment by the Company or to the Company of assets greater than [$100,000.00].
Non-Competition and Non-Solicitation Agreements:[23]	Each Founder and key employee will enter into a [one] year non-competition and non-solicitation agreement in a form reasonably acceptable to the Investors.

INVESTORS' RIGHTS AGREEMENT	
Non-Disclosure and Developments Agreement:	Each current and former Founder, employee and consultant will enter into a non-disclosure and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.
Board Matters:	[Each Board Committee shall include at least one Series A Director.] The Board of Directors shall meet at least [monthly][quarterly], unless otherwise agreed by a vote of the majority of Directors. The Company will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors. Company to enter into Indemnification Agreement with each Series A Director [and affiliated funds] in form acceptable to such director. In the event the Company merges with another entity and is not the surviving corporation, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume the Company's obligations with respect to indemnification of Directors.
Employee Stock Options:	All employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months]. [Immediately prior to the Series A Preferred Stock investment, [______] shares will be added to the option pool creating an unallocated option pool of [______] shares.]
Key Person Insurance:	Company to acquire life insurance on Founders [name each Founder] in an amount satisfactory to the Board. Proceeds payable to the Company.

RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT	
Right of First Refusal/ Right of Co-Sale (Take-Me-Along):	Company first and Investors second (to the extent assigned by the Board of Directors,) will have a right of first refusal with respect to any shares of capital stock of the Company proposed to be transferred by Founders [and future employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)], with a right of oversubscription for Investors of shares unsubscribed by the other Investors. Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.[24]

VOTING AGREEMENT	
Board of Directors:	At the initial Closing, the Board shall consist of [______] members comprised of (i) [name] as [the representative designated by [______], as the lead Investor, (ii) [name] as the representative designated by the remaining Investors, (iii) [name] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [______] person(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].
[Drag Along:	Holders of Preferred Stock and the Founders [and all future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by [the Board of Directors] [and the holders of ____% of the outstanding shares of Preferred Stock, on an as-converted basis (the "Electing Holders")], so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder's pro rata portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Certificate of Incorporation.][25]
[Sale Rights:	Upon written notice to the Company from the Electing Holders, the Company shall initiate a process intended to result in a sale of the Company.][26]

OTHER MATTERS	
Founders' Stock:	All Founders to own stock outright subject to Company right to buyback at cost. Buyback right for [__]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [__] months.
[Existing Preferred Stock:[27]	The terms set forth above for the Series [_] Preferred Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing Preferred Stock to this term sheet will be made at the Closing.]
No Shop/ Confidentiality:	The Company agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, for a period of [______] weeks from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this no-shop obligation and, prior to [______], closes any of the above-referenced transactions [without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction], then the Company shall pay to the Investors $[______] upon the closing of any such transaction as liquidated damages.][28] The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [______], as lead Investor, without the written consent of the Investors.
Expiration:	This Term Sheet expires on [_________, 20 __] if not accepted by the Company by that date.

EXECUTED THIS [____] DAY OF [____________________],20[____].

EXHIBIT A
Pre and Post-Financing Capitalization

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

Endnotes

1. The choice of law governing a term sheet can be important because in some jurisdictions a term sheet that expressly states that it is nonbinding may nonetheless create an enforceable obligation to negotiate the terms set forth in the term sheet in good faith. Compare *SIGA Techs., Inc. v. PharmAthene, Inc., Case No. C.A. 2627 ((Del. Supreme Court May 24, 2013)* (holding that where parties agreed to negotiate in good faith in accordance with a term sheet, that obligation was enforceable notwithstanding the fact that the term sheet itself was not signed and contained a footer on each page stating "Non Binding Terms"); *EQT Infrastructure Ltd. v. Smith*, *861 F. Supp. 2d 220 (S.D.N.Y. 2012); Stanford Hotels Corp. v. Potomac Creek Assocs., L.P., 18 A.3d 725 (D.C. App. 2011) with Rosenfield v. United States Trust Co.*, 5 N.E. 323, 326 (Mass. 1935) ("An agreement to reach an agreement is a contradiction in terms and imposes no obligation on the parties thereo."); *Martin v. Martin*, *326 S.W.3d 741 (Tex. App. 2010); Va. Power Energy Mktg. v. EQT Energy, LLC*, *2012 WL 2905110 (E.D. Va. July 16, 2012).* As such, because a "nonbinding" term sheet governed by the law of a jurisdiction such as Delaware, New York or the District of Columbia may in fact create an enforceable obligation to negotiate in good faith to come to agreement on the terms set forth in the term sheet, parties should give consideration to the choice of law selected to govern the term sheet.
2. Modify this provision to account for staged investments or investments dependent on the achievement of milestones by the Company.
3. The Charter (Certificate of Incorporation) is a public document, filed with the Secretary of State of the state in which the company is incorporated, that establishes all of the rights, preferences, privileges and restrictions of the Preferred Stock.
4. In some cases, accrued and unpaid dividends are payable on conversion as well as upon a liquidation event. Most typically, however, dividends are not paid if the preferred is converted. Another alternative is to give the Company the option to pay accrued and unpaid dividends in cash or in common shares valued at fair market value. The latter are referred to as "PIK" (payment-in-kind) dividends.
5. See Subsection 2.3.4 of the Model Certificate of Incorporation and the detailed explanation in related footnote 25.
6. For corporations incorporated in California, one cannot "opt out" of the statutory requirement of a separate class vote by Common Stockholders to authorize shares of Common Stock. The purpose of this provision is to "opt out" of DGL 242(b)(2).
7. Note that as a matter of background law, Section 242(b)(2) of the Delaware General Corporation Law provides that if any proposed charter amendment would adversely alter the rights, preferences and powers of one series of Preferred Stock, but not similarly adversely alter the entire class of all Preferred Stock, then the holders of that series are entitled to a separate series vote on the amendment.
8. The board size provision may also be addressed in the Voting Agreement; see Section 1.1 of the Model Voting Agreement.
9. The "broadest" base would include shares reserved in the option pool.
10. Note that additional exclusions are frequently negotiated, such as issuances in connection with equipment leasing and commercial borrowing. See Subsections 4.4.1(d)(v)-(viii) of the Model Certificate of

Incorporation for additional exclusions.

11. The per share test ensures that the investor achieves a significant return on investment before the Company can go public. Also consider allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the investor, so that the investor does not have the power to block a public offering.
12. Alternatively, this provision could apply on a proportionate basis (e.g., if Investor plays for ½ of pro rata share, receives ½ of anti-dilution adjustment).
13. If the punishment for failure to participate is losing some but not all rights of the Preferred (e.g., anything other than a forced conversion to common), the Certificate of Incorporation will need to have so-called "blank check preferred" provisions at least to the extent necessary to enable the Board to issue a "shadow" class of preferred with diminished rights in the event an investor fails to participate. As a drafting matter, it is far easier to simply have (some or all of) the preferred convert to common.
14. Redemption rights allow Investors to force the Company to redeem their shares at cost (and sometimes investors may also request a small guaranteed rate of return, in the form of a dividend). In practice, redemption rights are not often used; however, they do provide a form of exit and some possible leverage over the Company. While it is possible that the right to receive dividends on redemption could give rise to a Code Section 305 "deemed dividend" problem, many tax practitioners take the view that if the liquidation preference provisions in the Charter are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the Model Certificate of Incorporation), then there is no Section 305 issue.
15. Due to statutory restrictions, the Company may not be legally permitted to redeem in the very circumstances where investors most want it (the so-called "sideways situation"). Accordingly, and particularly in light of the Delaware Chancery Court's ruling in *Thoughtworks* (see discussion in Model Charter), investors may seek enforcement provisions to give their redemption rights more teeth - e.g., the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company's Board of Directors, or shall have consent rights on Company cash expenditures, until such amounts are paid in full.
16. Founders' representations are controversial and may elicit significant resistance as they are found in a minority of venture deals. They are more likely to appear if Founders are receiving liquidity from the transaction, or if there is heightened concern over intellectual property (e.g., the Company is a spin-out from an academic institution or the Founder was formerly with another company whose business could be deemed competitive with the Company), or in international deals. Founders' representations are even less common in subsequent rounds, where risk is viewed as significantly diminished and fairly shared by the investors, rather than being disproportionately borne by the Founders. A sample set of Founders Representations is attached as an Addendum at the end of the Model Stock Purchase Agreement.
17. The bracketed text should be deleted if this section is not designated in the introductory paragraph as one of the sections that is binding upon the Company regardless of whether the financing is consummated.
18. Note that Founders/management sometimes also seek limited registration rights.
19. The Company will want the percentage to be high enough so that a significant portion of the investor base is behind the demand. Companies will typically resist allowing a single investor to cause a registration. Experienced investors will want to ensure that less experienced investors do not have the right to cause a demand registration. In some cases, different series of Preferred Stock may request the right for that series to initiate a certain number of demand registrations. Companies will typically resist this due to the cost and diversion of management resources when multiple constituencies have this right.
20. See commentary in footnotes 23 and 24 of the Model Investors' Rights Agreement regarding possible extensions of lock-up period.
21. See commentary in introduction to Model Managements Rights Letter, explaining purpose of such letter.
22. Note that Section 402 of the Sarbanes-Oxley Act of 2003 would require repayment of any loans in full prior to the Company filing a registration statement for an IPO.
23. Note that non-compete restrictions (other than in connection with the sale of a business) are prohibited in California, and may not be enforceable in other jurisdictions, as well. In addition, some investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a Non-Compete/ Non-Solicit (and indeed the agreement may arguably be invalid absent such additional consideration - although having an employee sign a non-compete contemporaneous with hiring constitutes adequate consideration in jurisdictions where non-competes are generally enforceable). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Non-competes typically have a one year duration, although state law may permit up to two years. Note also that some states may require that a *new* Non-Compete be signed where there is a material change in the employee's duties/salary/title.
24. Certain exceptions are typically negotiated, e.g., estate planning or *de minimis transfers.* Investors may also seek ROFR rights with respect to transfers by investors, in order to be able to have some control over the composition of the investor group.
25. See Subsection 3.3 of the Model Voting Agreement for a more detailed list of conditions that must be satisfied in order for the drag-along to be invoked.
26. See Addendum to Model Voting Agreement
27. Necessary only if this is a later round of financing, and not the initial Series A round.
28. It is unusual to provide for such "break-up" fees in connection with a venture capital financing, but might be something to consider where there is a substantial possibility the Company may be sold prior to consummation of the financing (e.g., a later stage deal).

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