

Confidential Term Sheet
For A Proposed Series A Convertible Preferred Investment
In [_____]

I. SUMMARY

Issuer: [_____] , a Delaware corporation.

Purchasers: [ABC VENTURE FUND] (“ABC”) [and one or more other investors selected by ABC] (collectively referred to as the “Investors”)

Security: Series A Convertible [Participating] Preferred Stock (Series A)

Amount & Closing of Investment: \$[_,000,000] to be provided by ABC.
At least \$[_,000,000] and up to \$[_,000,000] in new capital to be provided by the other Investors. The closing of this investment (the “Closing”) is anticipated to occur on or before [_____].

Pre-Financing Valuation: \$[_____] fully diluted (including [10-20%]¹ of the total equity on a fully diluted basis being reserved under the employee option pool (the “Reserved Shares”). The Company's current capital structure is attached hereto as Appendix A (Part 1).

II. DESCRIPTION OF SERIES A PREFERRED STOCK

Dividends: [8]% [cumulative]² dividend³ prior to the payment of any other dividends, [payable in cash or shares of [common][Series A Preferred] valued at [the original purchase price][at the FMV of such shares as of the issue date].

Liquidation Preference: Upon a Liquidation Event (as defined below), the holders of Series A Preferred shall be entitled, before payment to holders of any other equity securities of the Company, to an amount equal in value to [__X]⁴ the original purchase price for such shares plus all accrued but unpaid dividends, whether or not declared. The holders of Series A Preferred shall then participate with the holders of the Common Stock on an as converted to Common Stock basis in the distribution of all of the remaining proceeds available upon the completion of a Liquidation Event [until the holders of Series A Preferred shall have received in the aggregate __X their original purchase price]⁵.

A Liquidation Event shall mean (i) a liquidation, dissolution or

¹ Rejuicing the option pool in the pre-money calculation pushes the dilution to the existing stockholders.

² The majority of deals have cumulative dividends; although we are seeing some non-cumulative deals.

³ Dividends can be payable in cash or converted into shares of Common Stock.

⁴ The trend for companies with significant revenue traction is for a 1X preference plus participation. Consider a multiple preference on a case-by-case basis. For extremely competitive cases, consider eliminating the participation element.

⁵ This language reflects a participating preferred with a cap. At a certain exit valuation, the investors participation element would be limited and they would instead convert to common to receive their proportionate share of the exit proceeds.

winding up of the Company, (ii) a merger, consolidation or similar transaction, or (iii) the sale, license or lease of all or substantially all of the Company's assets, unless the holders of a majority of the Series A Preferred elect otherwise.

Conversion:

Each share of Series A Preferred will be convertible, at any time, at the option of the holder, into shares of Common Stock at the conversion price then in effect. [All accrued and unpaid dividends, whether or not declared, shall be included in the conversion calculation]⁶ [or, at the holders option, be paid in cash on conversion)]⁷. The conversion price shall be subject to adjustment as provided in Anti-Dilution below.

The Series A Preferred shall automatically convert into Common Stock upon (i) the closing of a public offering by the Company of its common stock at a price equal to or exceeding [3-5]⁸ times the Series A Preferred conversion price then in effect in which the aggregate proceeds received by the Company, after deduction for underwriter commissions and expenses related to the issuance, is not less than \$[20-30]⁹ million (a "QIPO"), or (ii) the affirmative vote of holders of at least 51% of the Series A Preferred.

Pay-to-Play: In addition, any holder of Series A Preferred that does not exercise in full its preemptive right as provided below with respect to future equity issuances by the Company will automatically be converted into shares of [Common Stock] [Series A-1 Preferred, which will not contain any anti-dilution protection.]¹⁰

Anti-Dilution:

The Series A conversion price will be subject to adjustment for stock splits, stock dividends and similar event, as well as [full ratchet]¹¹ [standard [broad-based]¹² [narrow-based]]¹³ weighted average anti-dilution protection (with customary exclusions, including issuances of the Reserved Shares).

Performance ratchet: In the event the Company does not achieve [audited] net revenues of \$[_____] in calendar year [____], the then-prevailing conversion price for the Series A Preferred will automatically be reduced by [[__%][insert methodology]].

Preemptive Rights:

The holders of Series A Preferred shall have the preemptive right to

⁶ Pro-investor provision – includes cumulative dividends in the conversion calculation.

⁷ Pro-investor provision – permits dividends to be paid in cash.

⁸ The multiplier for a QIPO definition is of minimal value and can be traded if necessary.

⁹ The dollar threshold for a QIPO definition is of little value and can be traded if necessary.

¹⁰ This Pay-to-Play provision penalizes investors who do not participate pro rata in future rounds by converting their equity to common stock or removing their economic anti-dilution protection. Investors who have the ability/desire to fund future rounds will benefit from this provision. We are seeing pay-to-play only in a minority of current deals.

¹¹ No longer market – this is a pro-investor provision that ratchets the conversion price down to the issue price of any additional shares if lower than the current preferred conversion price.

¹² Market standard - Broad-based anti-dilution spreads the effect of dilutive issuances over a broad base of shares (includes all outstanding shares and options).

¹³ Narrow-based anti-dilution spreads the effect of dilutive issuances over a narrow base than broad-based anti-dilution (e.g., only includes the preferred stock and future issuances in the calculation).

purchase their pro rata share of future securities issuances by the Company on the same terms as such securities are offered to other purchasers.

Redemption:

Beginning on or after the [fifth]¹⁴ anniversary of the purchase of Series A Preferred Stock, [subject to the approval of the holders of 66% of the Series A Preferred]¹⁵, the Series A Preferred holders may elect to require the Company to redeem all (but not less than all) of their Series A Preferred holdings at the greater of (1) the original purchase price for such shares plus all accrued and unpaid dividends whether or not declared and (2) the fair market value of such shares.¹⁶

Voting Rights:

Holders of Series A Preferred shall vote together with the holders of all classes and series of capital stock of the Company on an as-if converted basis, except that the consent of the holders of at least [51%][2/3rds]¹⁷ of the Series A Preferred, voting as a separate class, shall be required for specified material actions, including the following:

- (1) changes to the charter (including changes to the authorized number of Series A Preferred) and by-laws that adversely effect the Series A Preferred;
- (2) effecting any Liquidation Event;
- (3) the issuance of any additional [equity-related] securities [senior to or on parity with the Series A Preferred];
- (4) declaring or paying any dividends other than in respect of the Series A Preferred Stock;
- (5) purchasing any of the Company's securities other than required redemptions of Series A Preferred Stock and repurchases under restricted stock/option agreements with employees;
- (6) diverging from the Board approved business plan/budget;
- (7) changes to the number of directors on the Board; and
- (8) transactions with any officer or stockholder of the Company, unless at "arm's length".

¹⁴ A redemption provision is fairly standard on the East Coast (less so on the West Coast), although infrequently exercised. When included, a 5-7 year trigger is standard.

¹⁵ This provision permits the majority to control the election to redeem; alternatively it can be made on a holder by holder basis.

¹⁶ Discuss valuation methodologies and ability to pay over time in installments.

¹⁷ Determine voting threshold depending upon ABC's percentage ownership of the Series A Preferred.

III. INVESTOR RIGHTS AGREEMENT

- Board of Directors:* The Board of Directors will consist of five members, as follows: two (2) directors ("Investor Directors") elected by the holders of Series A Preferred Stock, both of which shall be designated by ABC; two (2) directors (the "Common Directors") elected by the holders of Common Stock, voting as a separate class; and the fifth director (the "Mutual Director") shall be selected by mutual agreement of the holders of a majority of the Series A Preferred on the one hand, and the holders of a majority of the outstanding Common Stock on the other hand.
- Right of First Refusal:* With certain customary exceptions, no holder of [Common Stock][any shares of the Company's capital stock]¹⁸ shall be permitted to transfer any of such shares without giving a right of first refusal to the Company and, on a secondary basis, holders of the Series A Preferred on a pro-rata as converted basis.
- Tag-Along Rights:* If any holder of Common Stock holding more than 5% of the Company's fully-diluted capital stock (a "Selling Common Stockholder") desires to sell any of its shares in one or a series of transactions, the Investors¹⁹ shall have the right to participate in the transaction(s) on a pro rata basis on the same terms and conditions.
- Drag-Along Rights:* In the event that a sale or merger of the Company to an unaffiliated third party is approved by the Board and any required stockholder vote, all of the stockholders agree to vote in favor of and to transfer their shares in such transaction.
- Registration Rights:* The Investors shall be entitled to two demand registration rights and unlimited piggy-back and Form S-3 registration rights on customary terms.
- Information; Access:* The Investors shall be entitled to standard information rights (monthly and quarterly unaudited financial statements, annual audited financial statements and an annual operating plan and budget) and reasonable inspection rights.
- Select Remedies:* In the event (i) of a material breach of any of the provisions of the Stock Purchase Agreement or the Investors Rights Agreement by the Company [within one year from the closing], or (ii) the Company's failure to make any mandatory redemption payment in respect of the Series A Preferred, then the holders of the Series A Preferred shall have the right to designate a majority of the directors. Such right shall continue for so long as any such default continues.

¹⁸ Consider whether the preferred holders want to subject themselves to a ROFR.

¹⁹ This right is generally only available to the preferred holders.

*[Vesting Provisions*²⁰: The founders shares shall be subject to vesting as follows: [__]% of their current holdings will be fully-vested on closing and the remainder shall vest [25]% at the end of the first year of full-time employment after the closing and 1/48th per month thereafter. Upon a termination of employment for cause or a voluntary resignation by a founder, the Company shall have the right to repurchase such founder's unvested shares at \$0.01 per share[, and such founder's vested shares at fair market value]].

Employment Agreements:: The Founders will enter into [one] year employment agreements with the Company on terms acceptable to the Investors, which agreements shall contain [one year] noncompete arrangements, a corresponding [one year] severance provision, and other customary terms and conditions.

IV. MISCELLANEOUS PROVISIONS

Definitive Agreements:: The purchase of the Series A Preferred is subject to negotiation and execution of a definitive Stock Purchase Agreement, Investors Rights Agreement and such other documentation as is acceptable to the Investors containing the basic terms and conditions set forth herein, including such representations, warranties, covenants, terms, indemnities, and conditions as would be usual and customary for a transaction of this nature and which are mutually agreeable to the parties.

Exclusivity: For the period beginning upon execution of this Term Sheet by the Company and extending for [45] days thereafter, as a material inducement for the Investors to perform their due diligence, the Company, its officers, directors, shareholders²¹ and representatives shall not directly or indirectly disclose the existence of this Term Sheet or any of its terms and conditions, discuss nor negotiate the sale of any of the Company's securities, or the Company's business or any of the Company's material assets or properties (other than in the ordinary course), provide any information to or close any such transaction with any other party. The provisions of this exclusivity paragraph shall be binding upon the parties hereto.

Expenses: [If the transactions contemplated hereby close,] the Company will be responsible for the reasonable fees and expenses of the Investors related to this transaction, including all accounting, consulting and attorney's fees, up to an aggregate amount of \$[___],000.

Non-Binding Agreement: This term sheet is solely for the purpose of outlining a definitive agreement that may be entered into between the Company and the Investors. Except for the "Exclusivity" and "Expenses" provisions above, this Term Sheet only expresses the intent of the parties and is not a legally binding agreement, nor a commitment to purchase the Series A Preferred. Any such purchase shall only be made upon execution and delivery of the definitive documents referred to above.

²⁰ Non-market term – we see reverse vesting in a small minority of transactions.

²¹ Have the principal stockholders sign this term sheet if they are intended to be bound.

Expiration:

All terms contained herein shall immediately expire in the event that this Term Sheet is not executed by the Company and delivered to ABC by 5:30 pm on [_____].

Accepted for the Company

By: _____
Name:
Title:

Dated:

Accepted for ABC VENTURE FUND

By: _____
Name:
Title:

Dated: