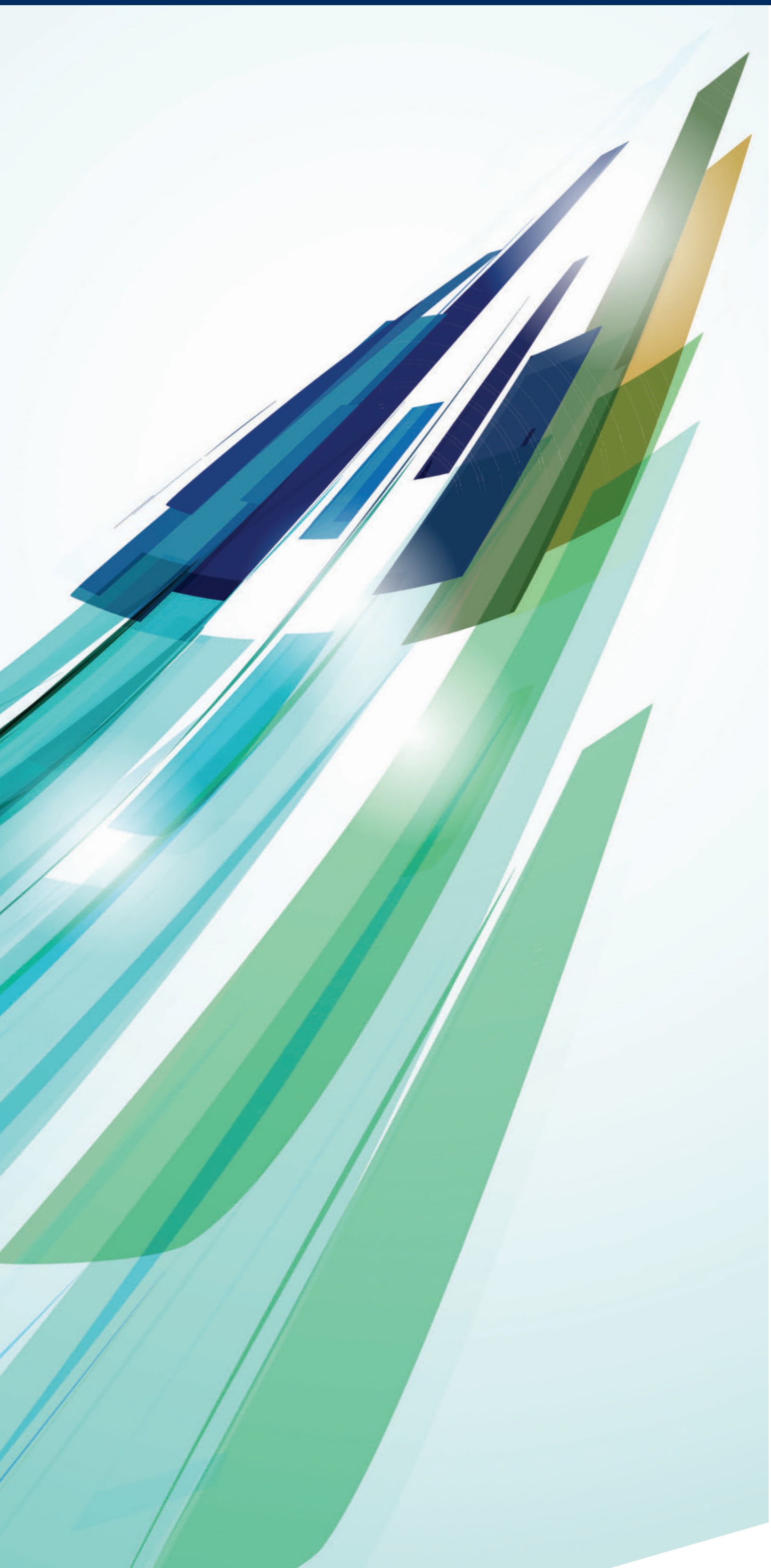
Q3 2019

ANATOMY OF A TERM SHEET: SERIES A FINANCING



A key milestone in the lifecycle of many successful companies is obtaining financing from angel or venture capital investors, but in negotiating with experienced investors entrepreneurs are usually at a distinct disadvantage because they are less familiar with standard terms that investors deal in on a daily basis. While we strongly suggest entrepreneurs consult their lawyers rather than negotiate a term sheet mano-a-mano, we know this often does not happen. Our goal in this pamphlet is to give readers the ability to better evaluate these documents themselves by introducing them to the standard terms in an early-stage equity financing.

Although the specific language in early-stage financing documents can vary considerably depending on, among other things, the investor (angel, VC or someone else) and the company's stage of development, the universe of possible terms is actually fairly well established. It is therefore possible, with an understanding of these basic terms, to form your own conclusions about a term sheet. For this pamphlet we use as our guide the model Term Sheet available from the National Venture Capital Association (NVCA) website (www. nvca.org) because it covers most of the terms you would expect to see in a term sheet for an early stage equity financing and it also includes some helpful annotations. The most recent version of the NVCA Term Sheet is attached to this pamphlet, but you can also download it from the NVCA website.

Benjamin M. Hron, Esq.
Stephen Fox, Esq.

FORWARD FOR Q3 2019

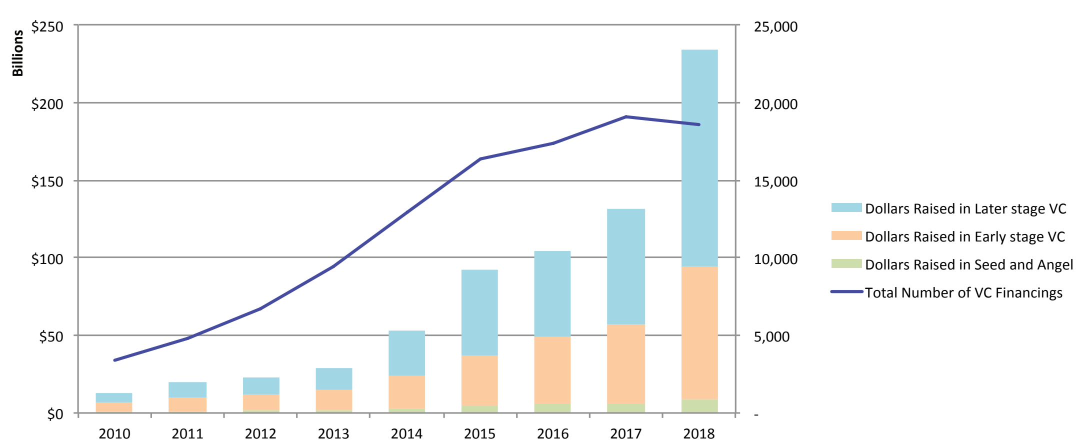
While there are still a few months to go in 2019, data collected by *Pitchbook*[1] about investments in privately held companies during the first half of the year shows the continuation of several trends observed over the past few years, including an increase in total dollars invested and a shift towards investments in later-stage companies. Completed data from 2018 showed that private companies in the United States raised record sums last year, as the amount invested in companies jumped to approximately $238 Billion from approximately $134 Billion in 2017. Interestingly, the number of financing deals actually fell to 18,633 from in 19,124 deals in 2017. The primary reason for this disparity is that deal activity in 2018 was most pronounced among later-stage companies, which raised more than 60% of all investment dollars in 2018, compared to their trailing-decade average of just 54%. On the other hand, early-stage and seed/angel-stage companies took in only 40% of venture financing dollars in 2018, compared to their trailing-decade average of approximately 46%. Initial data from the first half of 2019 indicates that this disparity has grown even wider.

In general, companies raising their first round of venture capital had a tougher time in the first half of 2019 compared to the same time period in 2018. Still, while the amount of capital raised in initial VC deals was down approximately 32% from a year earlier, initial investments in Car-Sharing, BCB Payments, Cannabis and E-Commerce companies in the first half of 2019 far outpaced investments in those spaces during the first half of 2018. On the flip side, among the industry verticals that fell out of favor in the first half of 2019 were Cryptocurrency / Blockchain (~88% decline in money raised from the first half of 2018), Robotics and Drones (~77%), AI & Machine Learning (~61%), Augmented Reality (~56%) and Wearables (~53%).

While 2019 is shaping up to be another record setting year overall for private companies to raise capital, there are reasons to believe the modest decline in early stage deals since 2017 may foreshadow a broader pullback in angel and venture capital investment in startups. Most concerning is the increasing volatility in global stock markets. While the overall dollars raised from initial public offerings of VC-backed companies in the first half of 2019 rose to approximately $29.2 billion compared to $26.6 billion during the same time period in 2018, the number of deals fell from 129 to 101 . Despite strong activity in M&A transactions (see Page 17), given that initial public offerings are such an important path to liquidity for investors in startups, any disruption in public markets inevitably has a trickle-down effect on early-stage investment. If the public markets (especially high-profile initial public offerings) continue to experience volatility throughout the second half of 2019, fundraising for early stage companies is likely to continue to be more difficult.

[1] Statistics are based on data available as of August 22, 2019.

ALL VC FINANCINGS IN THE UNITED STATES



Source: PitchBook Data, Inc.

McCARTER &ENGLISH

NATURE OF A TERM SHEET AND SUMMARY OF OFFERING TERMS

Introductory Paragraph

Fundamentally, a term sheet is just an agreement to try to reach an agreement, and therefore only a steppingstone (albeit an important one) on the path to financing. With that said, while the terms of an eventual financing may vary from those outlined in the term sheet, the term sheet is the first place lawyers on both sides will look to when preparing the actual financing documents. Any deviation from the term sheet must be justified; for instance, by a revelation about the company discovered during the investors' due diligence. Since such revelations are rarely favorable to the company, it is in the company's best interest to seek to negotiate the best terms possible at the term sheet stage.

Although the introductory paragraph of the NVCA's model term sheet makes clear that the term sheet does not, for the most part, create any legally binding obligations, it is important to be aware of three exceptions. The term sheet explicitly provides that the "No Shop/Confidentiality" and "Counsel and Expenses" provisions are binding on the parties. In addition, courts in some jurisdictions have found that even a non-binding term sheet requires the parties to negotiate in good faith, so the choice of law governing the term sheet may create another binding obligation (see the footnote to the introductory paragraph of the term sheet for more details). Because the scope and enforceability of these obligations depends on the law governing the term sheet a discussion of their potential impact is beyond the scope of this pamphlet so we strongly recommend consulting your attorney.

Offering Terms

The "Offering Terms" section of the NVCA's model term sheet summarizes the key economic provisions of the financing. This section is fairly self-explanatory, so we will limit our discussion to three points.

First, sometimes the investment will be divided into tranches spread across two or more Closing Dates, and later tranches may be subject to the company achieving certain milestones. If milestones are included, it is important that they be clearly defined and, if achievement or failure of a milestone cannot be objectively determined (i.e. is open to interpretation), that the mechanism for determining if/when the milestone is achieved also be clearly defined. Typically, determining if a milestone is achieved will fall to the investors, so it is in the company's best interest to ensure the milestones are sufficiently well defined to minimize the investors' discretion. Tranched investments are particularly common in the financing of life science companies, where milestones, such as the receipt of regulatory approval, are easy to clearly define, but tranches can also be tied to the achievement of certain sales or spending goals.

Second, the employee option pool referenced in the description of "Pre-Money Valuation" is typically set between 10% and 20% of a company's fully-diluted post-money capitalization at the time of a Series A financing. The principal factor in determining the size of the pool should be the need to incentivize current and future employees, so a company with a strong core team already in place should not need as large a pool. If the pool seems large to you, your investors may have a different expectation about the future growth of the company. The goal should be to establish a pool that is the right size to meet the company's needs for the foreseeable future.

Third, it is also important to note how the pre- and post-money valuations of the company are impacted by the employee option pool. The NVCA model term sheet treats the option pool as part of the pre-money valuation, resulting in an illusory increase in the pre-money valuation, which the guys at Venture Hacks (www.venturehacks.com) have dubbed the "Option Pool Shuffle." There is nothing inherently wrong with including an option pool in the pre-money valuation, but it is important for entrepreneurs to understand that doing so has real economic impact. To illustrate, consider a pre-money valuation of $5 million that does not include an option pool and a pre-money valuation of $6 million that includes an option pool equal to 20% of the company's fully-diluted capital. In the latter case, the option pool accounts for $1.2 million of the valuation, making the effective pre-money valuation only $4.8 million. Check out the Venture Hacks article for a more in-depth discussion of the impacts of the Option Pool Shuffle.

DIVIDENDS

The operative provisions in the NVCA's model term sheet are grouped according to the NVCA model financing document in which they are found, beginning with the Charter, which defines the rights and preferences of the shares being purchased in the financing. The next several sections in this pamphlet deal with the terms in the Charter.

Dividends

Dividend provisions are often overlooked by entrepreneurs, but can have a significant effect on the economics of a financing. The model term sheet includes three alternative dividend provisions, one providing that dividends will be paid only when also paid to the common stock (company favorable), and the others providing for "accruing" dividends on the preferred stock (investor favorable). In the second and third alternatives, the more company favorable formulation provides that the preferred stockholders have a right to receive a dividend "when and if declared by the Board." If this language is not included, the right to receive dividends is not contingent on Board approval and unpaid dividends simply remain as obligations of the company to the investors.

It is important to note that in practice even accruing dividends not requiring Board approval are never (in our experience) actually paid out in cash unless and until the company liquidates (and then only if there's enough cash available, which there often is not); rather, typically they eventually convert to common stock when the underlying preferred stock converts (we discuss conversion in the section on "Conversion and Anti-dilution"). Like interest on a debt, accruing dividends may "compound" periodically, meaning dividends accrue on dividends. The more frequently dividends compound, the faster they accrue.

The economic impact of dividends is most significant to the entrepreneur (and to the investor) if the company is eventually sold for a modest amount. If a company is wildly successful, the value of the accrued dividends relative to the rest of the company will be trivial, and if a company fails there won't be any money to pay the dividend on liquidation. Between these extremes, however, dividends can take a significant bite out of an entrepreneur's payout when a company is sold. Since few companies become wildly successful, entrepreneurs should try to eliminate accruing dividends, or at least reduce their effect by (a) keeping the dividend rate low (5-8% is the standard range in normal economic times), (b) insisting that the dividends do not compound and/or (c) providing that the dividends do not begin to accrue until sometime in the future (typically 1-3 years from the date of the financing).

LIQUIDATION PREFERENCE

We continue our discussion of the Charter provisions with the liquidation preference, which is the most important economic term in the term sheet after the valuation because it establishes the relative rights of the investors and the common stockholders with respect to assets (including intellectual property) available for distribution when the company winds up its business. While the term "liquidation preference" suggests the provision applies only if the company goes belly-up, in reality there is likely to be little to fight over if this happens. The real impact of the liquidation preference comes into play when there is a "Deemed Liquidation Event," such as an acquisition by another company, which generates cash or some other form of consideration or other assets (ex. stock of the acquiring company) to be divided among the stockholders.

The model term sheet includes three alternative provisions for the liquidation preference. They are (1) non-participating preferred stock (most company favorable), (2) full participating preferred stock (most investor favorable) and (3) participating preferred stock with a cap. In all three alternatives, preferred stockholders are entitled to receive a "preference" – typically some multiple of their original investment (1x to 3x) plus any accrued and unpaid dividends – before any payment is made to the common stockholders. "Participating" preferred stockholders are also entitled, after payment of their preference amount, to share with the common stockholders, on an as-converted-to-common basis, in the distribution of any remaining proceeds (this is called "double dipping"). If there is a right to participate with the common, the right may be capped at a multiple of the preferred stockholders original investment. It is important to note that investors will always have the option to convert their preferred stock to common stock if it would result in a larger payout, which could be the case with non-participating preferred and participating preferred with a cap if the amount available for distribution exceeds the preference amount or the cap, as applicable. Thus, investors will never receive less in liquidation than they would have if they simply owned common stock. It is also important to note, however, that the payment of the liquidation preference when there is a liquidation or Deemed Liquidation Event can typically be waived by holders of a majority of the outstanding preferred stock, which may allow the company to negotiate to reduce or eliminate payment of the preference in certain circumstances.

As with dividends, the economic impact of the preference and the participation rights depends on the company's eventual fate. When evaluating a term sheet, it's a good idea to do some quick math to determine what the different groups of stockholders (common and preferred) would take home if the company were sold for different values (for this exercise, assume the entire proceeds of the sale go to the stockholders). Then see how changing the proposed preference and participation rights impacts these results.

Entrepreneurs should note that investors may find it counterproductive to impose a very investor-favorable liquidation preference on a company for two reasons. First, it reduces the founders' economic incentive to build the business. Second, later investors will likely want similar terms, which would leave the earlier investor negatively impacted by the same terms it imposed on the company. Don't be afraid to raise these points (particularly the first one) in negotiating the liquidation preference, but also be prepared to make tradeoffs, if necessary: if your potential investor insists on having a participation right, focus on pushing down the liquidation preference and adding a cap on participation; if the potential investor wants a 3x liquidation preference, say no to participation.

VOTING RIGHTS AND PROTECTIVE PROVISIONS

Voting Rights and Protective Provisions define when investors vote with the other stockholders and when they have the right to a separate vote. Having separate voting rights in certain circumstances is important to investors because it prevents them from being outvoted by other stockholders with competing interests. The circumstances in which investors have the right to a separate vote will typically include at least (a) significant corporate events (ex. a sale of the company) and (b) actions that could adversely affect the rights specific to such investors (ex. amending the corporate Charter or changing the composition of the Board of Directors). Sometimes more company-specific protective provisions will be included, such as the sale of a specific division of the company's business or whether the company can create and distribute cryptocurrency. Note that the scope of the protective provisions should be commensurate with the size of the investment, so angel investors should not necessarily have the right to a separate vote on actions that typically require a separate vote by a VC investor, such as taking on debt or changing the size of the Board of Directors.

Most of the time you should not expend any energy fretting over the protective provisions, but do watch out for two things. First, make sure the percentage required to approve any action subject to the protective provisions is not so high as to make obtaining approval burdensome. Typically the threshold should be high enough so that approval of the lead investor(s) is always necessary, but not so high that a minor investor has a block. This becomes ever more important as the number of investors grows. Second, be sure the protective provisions don't unduly inhibit the company's freedom of action by requiring stockholder approval for routine matters. The Protective Provisions should protect the investors, not give them an additional means of controlling the company. If the investors are seeking a stockholder vote for day-to-day decisions, suggest instead that such decisions be made by the Board including the director(s) appointed by the investors. We discuss matters that typically require approval of the investors' director(s) in Management Rights and Investor Director Approval.

CONVERSION AND ANTI-DILUTION

In this section we look at when an investor's preferred stock may or must convert to common stock, and how the conversion ratio may be adjusted in certain circumstances.

Optional Conversion and Mandatory Conversion

Preferred stock typically converts to common stock either:

(a) at the option of the stockholder ("Optional Conversion"); or

(b) automatically (i) at the time of the company's initial public offering (usually subject to the public offering share price being at least X times the per share price paid by the investors) or (ii) if at least X% of the investors agree to convert all preferred stock held by all investors (both (i) and (ii) being examples of "Mandatory Conversion").

The conversion provisions are important to the investors – who do not want to be forced to convert before it is most advantageous to them – but of little consequence to the company, so they generally are not the subject of negotiation.

For a Mandatory Conversion upon an IPO the threshold public offering price, if there is one, is sometimes a topic of disagreement (typically 3x-5x the original purchase; with a higher threshold giving the investors more control over the timing and terms of an IPO), but it is important to keep in mind that investor approval will always be required for an IPO regardless of the threshold (either explicitly or because of the amendments to the corporate charter that will be required before the company goes public). The other issue of some concern to the company is what percentage of investors can compel all investors to convert to common. The company prefers that the percentage required is not so high as to make obtaining approval burdensome. Typically, the percentage required to force conversion is the same as that required to approve matters subject to the investors' Protective Provisions (discussed in Voting and Protective Provisions).

Anti-dilution Provisions

While the timing of conversion is not a very hot topic in negotiating a term sheet, the anti-dilution provision can be if the investors decide to play hardball. The ratio at which preferred stock converts to common stock is initially set at 1:1, but the ratio is typically subject to adjustment in a variety of circumstances. Certain adjustments merely compensate the investor for changes in the company's capital structure – for instance those caused by a stock split, reverse stock split or stock dividend – without altering the economics of the preferred stock. Other adjustments, however, are intended to protect the investor against dilution caused when the company issues shares at an effective price-per-share lower than the price-per-share paid by the investors (a future financing at a lower price is called a "down-round"). These adjustments are referred to as "price-based" anti-dilution protection.

Price-based anti-dilution protection operates by increasing the number of shares of common stock into which a share of preferred stock converts (i.e. it increases the conversion ratio) and has the effect of causing the company's common stockholders (who do not have anti-dilution protection) to be diluted twice: once by the issuance of the shares to the new stockholders and a second time as a result of the adjustment to the conversion price of the preferred stock. The anti-dilution protection provisions can, therefore, have a significant economic impact. There are two types of price-based anti-dilution protection typically found in angel and VC financings: full ratchet (very investor favorable) and weighted average (less investor favorable). Note that the third alternative – no price-based anti-dilution protection (company favorable) – is often seen in pre-VC financings, but almost never in VC deals.

Full ratchet anti-dilution adjusts the conversion price of outstanding preferred stock to that of the stock being sold in the new offering, thereby putting the existing investors in the same position they would have been in if they had purchased their shares at the new, lower price per share. This type of anti-dilution protection is extremely favorable to the investor and extremely

CONVERSION AND ANTI-DILUTION

rare in Series A financings, so it should be strongly resisted by the company. If you receive a term sheet with a full-ratchet anti-dilution provision, it should be a red flag that the rest of the terms may be heavily investor favorable. Fortunately, few investors seek to impose full ratchet anti-dilution.

Weighted average anti-dilution reduces the conversion price of outstanding preferred stock in a proportionate manner taking into account both the number of shares being issued and the price per share. In this way the conversion ratio is adjusted to somewhere between the original ratio and the ratio that would apply after full ratchet anti-dilution protection. Weighted average anti-dilution may be either "broad" or "narrow" depending on whether certain derivative securities (such as options and warrants) are included in the calculation of the company's existing capital, with a "broad" formula resulting in less dilution adjustment (i.e., more company favorable) than a "narrow" formula. The NVCA term sheet presents a typical broad based anti-dilution formula: the number of shares outstanding for purposes of the formula (the "A" variable in the NVCA term sheet) includes not just common stock actually outstanding and common stock issuable on conversion of outstanding preferred stock, but also common stock issuable upon exercise of outstanding options. The formula could be made broader by, for instance, including all shares of common stock that may be issued out of the company's option pool (not just those covering options already granted). The formula could be made narrower by, for instance, only including common stock issuable upon exercise of outstanding options that have vested. In negotiating the term sheet, remember that while the breadth of a weighted average anti-dilution formula does matter, it is much less important than the choice between weighted average and full ratchet anti-dilution.

Regardless of the type of anti-dilution protection, the Charter typically includes a number of exceptions allowing a company to issue additional shares in specified circumstances without any adjustment to the conversion price of the outstanding preferred stock. The NVCA term sheet includes standard exceptions for (a) shares issued upon conversion of convertible securities (conversion does not result in further dilution), (b) stock splits, dividends and the like pertaining to the company's common stock (pro rata adjustments for these events are provided for in the Optional and Mandatory Conversion provisions), (c) equity incentives for employees and others (i.e. shares issued out of the company's option pool) and (d) shares issued in certain types of transactions. It is also common, and generally good for the company, to include a provision allowing X% of the investors to waive anti-dilution protection on behalf of all investors (the percentage required is typically the same as for compelling a mandatory conversion).

Of course, the best way to avoid the double-dilution created by anti-dilution provisions is to keep growing the value of your company so the stock price keeps rising. Herein lies an important lesson about negotiating valuation in a financing: a higher valuation increases the probability of a future down-round financing, so it may be better to accept a lower valuation that you are confident you can improve on before you'll next need to raise capital.

Weighted Average Anti-Dilution Formula:

CP2 = CP1* (A + B) ÷ (A + C)

"CP2" = Conversion price immediately after the new shares are issued.

"CP1" = Conversion price immediately before new shares are issued.

"A" = Number of shares of common stock outstanding immediately prior to issuing new shares (treating as outstanding all shares of Common Stock issuable upon exercise of options outstanding or upon conversion or exchange of convertible securities outstanding).

"B" = The aggregate consideration received for new shares, divided by CP1.

"C" = Number of new shares issued in the transaction.

PAY-TO-PLAY

The Pay-to-Play provision is another term that can have significant economic impact on the investors and the company, and it dovetails nicely from the discussion of Anti-dilution Provisions in the prior section, because in a down-round financing (where the company's valuation is lower than in the prior round) it helps mitigate the negative impact of anti-dilution protections. A Pay-to-Play provision provides that any investor failing to fully exercise its "Preemptive Rights" to participate in a future financing (discussed later) will have some or all of its shares of preferred stock converted into common stock or into another class of preferred stock with lesser rights (losing its anti-dilution protection and other rights in the process).

A Pay-to-Play provision is clearly company-favorable because it penalizes investors who do not participate in future rounds when the company needs more funding, but it also has positive consequences for those investors who do invest in future rounds because it prevents other investors from free- riding. Lead investors are often willing to accept a Pay- to-Play provision (and some even prefer to include one) where there is a syndicate of smaller investors who the lead investor wants to ensure will continue to play ball, particularly if the lead investor has the voting power to block any future financing where it does not want the Pay-to-Play to apply (see our earlier discussion of Voting Rights and Protective Provisions). Smaller investors, by contrast, are most likely to object to a Pay-to-Play.

Note that the Pay-to-Play can be applied to "up" or "down" rounds, though investors are usually much more willing to participate when the company's valuation is on the rise.

TIPS & TRENDS

Venture Capital investments in companies in New England is more concentrated in the Healthcare sector in comparison to the U.S. as a whole. On average over the past ten fiscal quarters, companies in the Healthcare sector have received 44% of the dollars invested in companies based in New England, compared to 25% received by companies in the Information Technology sector.

Conversely, venture financings across the country are significantly more focused on the Information Technology sector. Over the same time period throughout the United States, companies in the Healthcare sector have received only 25% of venture financing dollars, while those in the Information Technology sector have received 51%.
(See charts on Page 10)

REDEMPTION RIGHTS

The NVCA model term sheet includes a typical Redemption Rights provision entitling investors to require the company to repurchase all of the outstanding shares of stock held by the investors at a certain point in the future (typically five years from the date of a Series A financing, give or take a year or two). The redemption price is typically the original price paid by the investors plus any accrued and unpaid dividends. Exercising Redemption Rights usually requires approval of at least X% of the investors, where the applicable percentage is generally the same as that required to approve actions under the Series A Protective Provisions (discussed earlier), though sometimes the presumption is flipped such that redemption is required unless at least X% of the investors waive it (called "mandatory" Redemption Rights).

In theory, Redemption Rights are beneficial to investors because they provide an exit in the event the company turns out to be successful enough to survive, but not successful enough to go public or be acquired by the time the investors need liquidity (VC funds usually have a ten year lifespan). In practice, however, Redemption Rights are almost never exercised because even if the company is still around (and has not gone public) when the Redemption Rights mature, it probably does not have sufficient cash available to repurchase the investors' shares. Because Redemption Rights are of limited value in practice, Investors often do not bother requesting them. When they do request Redemption Rights, they will often insist that the Charter provide for penalties if the company fails to redeem the investors' shares when the Redemption Right is exercised – for instance, the conversion ratio may be increased (see the section on "Conversion and Anti-dilution") or the investors may obtain the right to elect a majority of the company's Board of Directors until all the investors' shares are redeemed – but even the penalties are sometimes not enforced if the investors believe doing so would only further harm the company's prospects. The most important impact of the Redemption Rights (and any associated penalties), therefore, is that it gives the investors leverage to extract concessions from the company. For instance,

the investors may use the threat of exercising their Redemption Rights to compel reluctant founders to take the company public or accept an acquisition offer.

Redemption Rights are typical in Series A financings (though not in earlier seed financings) and entrepreneurs should focus on minimizing their impact rather than eliminating them altogether. The impact of Redemption Rights can be reduced by (a) pushing for optional rather than mandatory Redemption Rights, (b) minimizing the interest rate to be accrued for any unredeemed shares (c) lengthening the time before the rights mature or trigger any other economic inducements for the company to redeem the shares (beware of anything in the term sheet that accelerates maturity in certain circumstances, such as a material change in the company's business), (d) providing that any payout in a redemption is made over a lengthy period of time (preferably at least 3 years) and (e) ensuring that the consequences of failing to redeem the investors' shares are not too draconian (for instance, where the investors earn interest on the unpaid amounts until redemption while still also accruing dividends on the unredeemed shares).

Finally, it is worth noting that on occasion the company can negotiate for a redemption right of its own, entitling it to call (i.e. require the sale back to the company of) the investors' shares at a future date, though the redemption price will necessarily be higher than for an investor Redemption Right.

STOCK PURCHASE AGREEMENT

In this section we move away from the Charter provisions to discuss the Stock Purchase Agreement ("SPA"), the primary purpose of which is evident from its title: it is the contract wherein the investors agree to buy the shares of stock that the company is offering to sell. The financial terms of the investment, including any portion of the investment subject to achievement of milestones, will be set forth in the SPA (see the discussion of Offering Terms in the Section on "Nature of a Term Sheet and Summary of Offering Terms"). The primary importance of the SPA, however, lies in the terms and conditions it places on the financing, which serve primarily to protect the investors.

Representations and Warranties

The primary way in which the SPA protects investors is through the inclusion of "Representations and Warranties" ("R&Ws") about the company's business. R&Ws are statements about facts existing at the time a contract is signed that are made by one party to induce the other party to enter into the agreement. In a financing, a company is typically required to make R&Ws about everything from the company's capital structure to its ownership of relevant intellectual property and its compliance with applicable laws to ensure it has disclosed to the investors all information that might materially impact their decision to invest. If any of the R&Ws are later found to be incorrect, the company may be liable to the investors for damages. Note that it is generally accepted that investors will make R&Ws to the Company confirming their eligibility to participate in the offering (usually this means confirming they are "accredited investors" and are not disqualified from participating in the offering for any reason), though these R&Ws are not typically mentioned in the term sheet.

In most financings, the lawyers spend more time negotiating the R&Ws than any other section of the financing documents, but at the term sheet stage the only thing entrepreneurs usually need to worry about is whether and to what extent the company's founders are being asked to personally make R&Ws about the company's business. Founders' R&Ws are most common where the founders are receiving some liquidity in the transaction (which is extremely rare in a Series A financing) or where there is particular concern over an important topic of disclosure, such as intellectual property. The principal rationale for requiring founder R&Ws in addition to company R&Ws is economic: any damages paid by the company to compensate the investors also reduce the value of the company, and therefore of the investors' shares, while damages paid directly by the founders have no impact on the value of the company. These days it is rare for a VC in the U.S. to require separate founder R&Ws, but when they are included the investors may insist that the founders put some or all of their shares of company stock in escrow as security in case there is a breach of the R&Ws.

There are many ways in which founder R&Ws, and the founders' liability for breaches of R&Ws, can be limited; for example by: (a) limiting the categories about which the founders are required to make R&Ws, (b) providing that the R&Ws don't survive (i.e. can't be enforced) after a certain date (typically 6-24 months after the financing) or (c) capping the founders' liability (often at an amount equal to the value of the founders' ownership interest in the company). The appropriate type and scope of the limitations is, however, closely tied to the language of the R&Ws to be negotiated by the lawyers, so if an investor insists on providing for founder R&Ws in the term sheet, entrepreneurs are usually best off simply seeking to add language that those R&Ws will be subject to limitations to be negotiated and included in the final transaction documents. Finally, note that founder R&Ws are almost never appropriate beyond a Series A financing.

Conditions to Closing

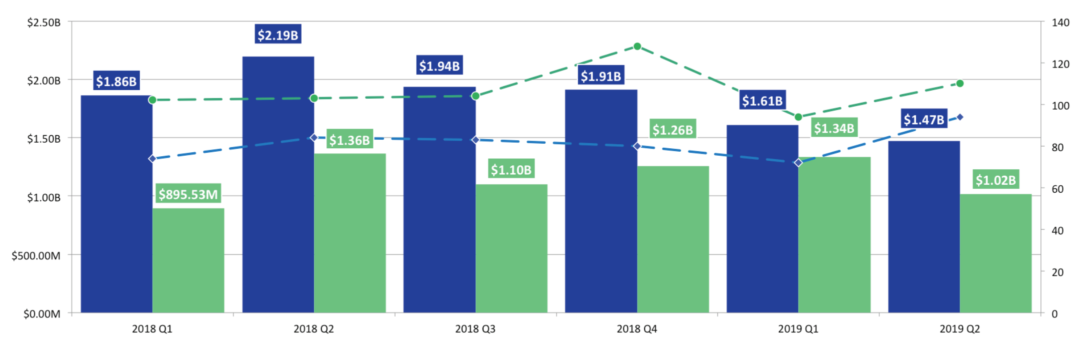
Conditions to Closing can protect the investors by requiring the completion of certain tasks and/or the occurrence of certain events between the time the SPA is signed and the actual completion of the transaction (called the "closing," which is when the investors actually pay for their shares). For instance, the SPA may require that as a condition to the investors' obligation to close, the founders' must sign non-competition agreements. In practice, however, conditions to closing often never come into play because the parties do not sign the SPA until all of the would-be conditions have already been satisfied, so entrepreneurs should not worry about this provision in the term sheet unless it includes a condition that is clearly outrageous or unlikely to be satisfied.

STOCK PURCHASE AGREEMENT

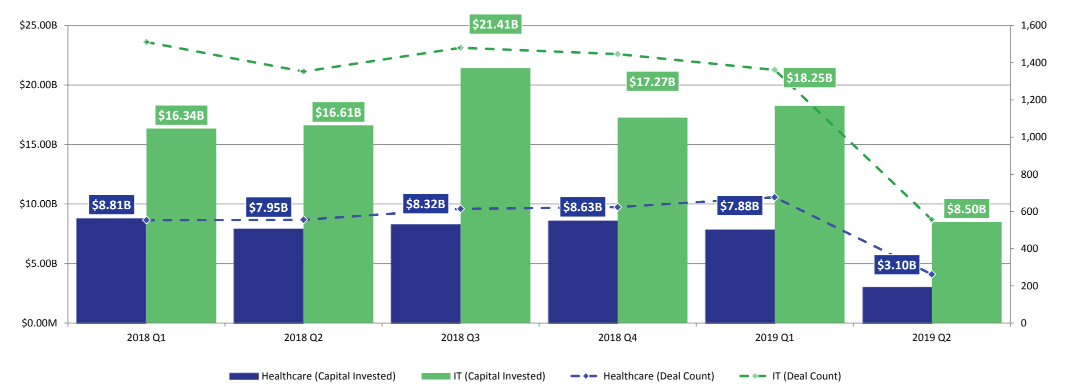
Counsel and Expenses

This section serves two purposes: (a) to specify which party's lawyers will initially draft the transaction documents; and (b) to establish the extent to which the company will pay the investors' legal fees. First, note that any advantage generally conferred by drafting is significantly diminished where, as in a typical Series A financing, the range of terms is fairly well understood and accepted; so if the investors insist that their counsel prepare the initial drafts of the financing documents, it is generally not worth arguing unless you believe it would be significantly more cost effective to have your lawyers draft the documents. Second, company payment of investor legal fees is also standard in venture financings (though not in earlier stage financings), but there are two ways in which companies often seek to limit their responsibility for such fees: by placing a cap on the dollar amount of the fees and/or by limiting or eliminating the obligation to pay fees if the transaction isn't completed. Avoiding payment of fees if the transaction doesn't close is typically more important to a company than capping the fees because absent completion of the financing the company likely will not have sufficient funds available to pay its own lawyers, much less the investors' lawyers. Even if the company is not required to pay fees if the transaction doesn't close, a fee cap is still a reasonable request and can serve to discourage over- lawyering.

VC FINANCINGS IN NEW ENGLAND



VC FINANCINGS IN THE UNITED STATES



REGISTRATION RIGHTS

The next several sections concern the provisions located in the "Investor Rights Agreement," "Right of First Refusal and Co-Sale Agreement" and "Voting Agreement," which together give the investors a variety of contractual rights vis-à-vis the company and the company's other stockholders. While the provisions contained in these three agreements are common to most VC financings, it is important to note that the titles of the agreements and the mix of provisions in each agreement can vary. We begin with the Investor Rights Agreement.

Registration Rights

The Registration Rights provisions in the NVCA term sheet give the investors the right to make the company register their shares with the Securities and Exchange Commission, which is a prerequisite to selling shares in the public markets (i.e. NYSE, Nasdaq, etc.). There are three types of registration rights typically granted to investors: (1) Demand Registration allows the investors to compel registration of their shares after some period of time following the offering, subject to certain conditions; (2) S-3 Registration allows the investors to compel registration at any time if the company meets the eligibility requirements for an "S-3" registration statement (which usually means that the company is already publicly traded); and (3) Piggyback Registration allows the investors to include their shares in any other registration of securities the company undertakes, subject to limitations on the number of shares that can be registered in some circumstances. The remaining Registration Rights provisions in the NVCA term sheet, none of which is generally the subject of negotiation, are "Expenses," which compels the company to pay the cost of a registration (which can be significant), "Lock- up," whereby the investors agree that they will not sell their shares for a given period of time after the company's initial public offering, and "Termination," which specifies when the rights terminate.

Of the three types of registration rights, Demand Registration rights are by far the most important because the investors can compel the company to undertake the costly and time-consuming process of an initial public offering. From a strategic standpoint, however, Demand Registration rights are very similar to Redemption Rights: while they give the investors an exit opportunity, in practice they are almost never exercised because if the company has not gone public it is likely because either the company is not ready or the market conditions are not favorable. As with Redemption Rights, Demand Registration rights give the investors leverage against the company that they can use to extract concessions at a later date.

Registration rights are standard in a Series A financing and, as noted above, of limited consequence to the company, so any negotiation is usually best left to after the term sheet is signed. If investors in a pre-Series A financing require registration rights, the company should insist that they agree up-front to subordinate those rights to the registration rights of future venture capital investors. The points that are sometimes negotiated at the term sheet stage are: (1) the threshold percentage of investors required to trigger Demand Registration (see the discussion of voting thresholds in the section on "Voting Rights and Protective Provisions"); (2) the earliest date the investors may exercise Demand Registration rights (5 years from the date of the financing is typical for a Series A financing, which may be reduced as low as 3 years for later-stage venture rounds); (3) the number of times the investors may exercise Demand Registration rights (typically 1-2 total) and the frequency with which the investors may exercise S-3 Registration rights (typically 1-2 per year); and (4) the minimum aggregate offering price for any Demand Registration (typically the same threshold as would trigger a Mandatory Conversion) or S-3 Registration (should be no less than $1M). Note that the threshold percentage of investors required to trigger S-3 Registration is less important (and typically much lower) than for Demand Registration because the burden on the company is much less.

Finally, it is worth noting that companies are sometimes able to negotiate for S-3 and Piggyback Registration rights for founders and even for other common stockholders, provided that these rights are subordinated to the investors' registration rights. Without registration rights, common stockholders must wait to sell their shares to the public until either they qualify for an exemption from registration, which usually comes with inconvenient conditions and restrictions, or the Board of Directors decides to register their shares, so obtaining registration rights for some or all of the company's common stockholders is arguably more important that attempting to restrict the registration rights of the investors.

MANAGEMENT RIGHTS AND INVESTOR DIRECTOR APPROVAL

If you're following along with the NVCA term sheet, please note that we've combined the discussion of "Management and Information Rights" and "Matters Requiring Investor Director Approval" into one section because they both relate to the role of investors in the management of the company. We'll return to the "Right to Participate Pro Rata in Future Rounds" provisions (which fall between this section's two topics in the NVCA term sheet) in the next section.

Management and Information Rights

Management and Information Rights serve to ensure that even those investors who will not have the right to appoint a member of the company's Board of Directors are able to obtain certain information about the operation and finances of the company. The obvious reason investors insist on receiving these rights is that they want to keep tabs on the companies in which they invest, but this is not why some investors require a "Management Rights letter" from the company. Without going into too much extraneous detail, receipt of a Management Rights letter is necessary for any venture capital fund that manages assets subject to the Employee Retirement Security Act of 1974 (ERISA), which many VC funds do, because such funds must have certain management rights in their portfolio companies to avoid being subject to certain obligations under ERISA. Note that while information rights are generally dealt with in the Investor Rights Agreement itself, the Management Rights letter is actually a separate document.

Management and information rights should be non-controversial and typically are not the subject of negotiation at the term sheet stage. If the round includes a number of small investors, the company (and the lead, i.e. "Major," investors) may want to limit who is entitled to management and information rights; though providing rights to a few additional investors is usually of minimal practical consequence to the company. The frequency and timing with which the company is required to deliver information to the investors (typically within 30-45 days following the end of each month or quarter and within 90-120 days following the end of each fiscal year) is also of little practical consequence because companies are often producing this information for internal purposes anyway. Later-stage companies may also be required to deliver audited financials following the end of each fiscal year, which is a material additional expense for the company, but audited financials are rarely requested, and almost never appropriate, for early-stage companies. Note that any investors who have information rights should be required to agree to keep the information they receive confidential, and a standard confidentiality provision should be included in the Investor Rights Agreement.

Investor Director Approval

The Investor Director Approval provisions are, along with the Protective Provisions we discussed previously, the primary mechanism for the investors to exert control over the activities of the corporation. Approval of the investors' director(s) is often required for matters that could materially impact the company where seeking stockholder approval would either be inappropriate (because of the subject matter) or unduly burdensome. The NVCA term sheet includes a laundry list of matters that may require approval of the investors' director(s), but the list is by no means exhaustive.

While companies are better off minimizing the decisions requiring approval of the investors (through the Protective Provisions) or their directors, being required to obtain approval of directors is preferable to being required to obtain stockholder approval for two reasons. First, the procedure for obtaining director approval is much simpler than for obtaining stockholder approval. Second, and arguably more important, directors have certain "fiduciary duties" towards the company and its stockholders (all of them) that prohibit them from putting their own interests ahead of the company's, whereas stockholders are almost always entitled to act selfishly. Therefore, in negotiating the Investor Director Approval provisions it is a good idea to be pragmatic: attempt to eliminate from the approval requirement any actions that should be routine, but don't get too worked up over the need to obtain approval of the investors' director(s) for matters that are likely to only arise periodically.

RIGHT TO PARTICIPATE PRO RATA IN FUTURE ROUNDS (a/k/a PREEMPTIVE RIGHTS)

As a preliminary matter, note that the "Right to Participate Pro Rata in Future Rounds" is more commonly referred to as "Preemptive Rights" or the "Right of First Offer." They are also sometimes referred to as the "Right of First Refusal," though this term is more often used to refer to the right to purchase shares offered for resale by a stockholder (which is covered later).

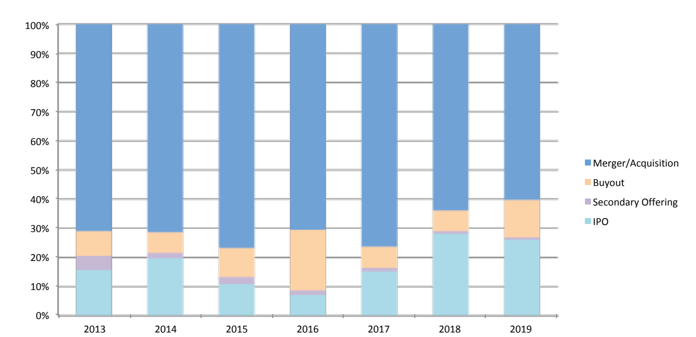
Preemptive Rights give investors the first right to purchase securities offered for sale by the corporation in the future, subject to a few exceptions (typically the same as the exceptions to the Anti-dilution Provisions). There are three basic varieties of Preemptive Rights: (a) each investor is entitled to purchase just that portion of the offered securities necessary to allow it to maintain its percentage ownership of the company (i.e. if the investor owns 10% of the company before the offering, she would be entitled to purchase 10% of the new securities being offered), (b) each investor may purchase some multiple of its pro rata portion (i.e., if a 2X right, an investor owning 10% of the company before the offering would be entitled to purchase 20% of the securities offered) or (c) the investors, collectively, are entitled purchase all of the securities offered by the corporation and each investor is entitled to purchase its pro rata portion of the total based on ownership relative to other investors with Preemptive Rights. In all three varieties, investors may also have the right to purchase a pro rata portion of any securities not subscribed for by other investors with Preemptive Rights (this is called an "Over-Allotment Right").

Preemptive Rights are standard in Series A deals, but it is generally in the company's interest to limit their scope so it has greater flexibility to raise money from outside investors. Ideally this means only giving investors the right to maintain their pro rata ownership in the company, though an Over-Allotment Right is often granted, as in the NVCA term sheet, so the investors as a whole have the opportunity to maintain their pro rata ownership even if not all investors elect to participate. Another way Preemptive Rights are sometimes limited is by only granting them to "Major" investors, usually being venture capitalists and large angel investors. Note that limiting the scope of the Preemptive Rights is considerably less important where the investors are subject to a Pay-to-Pay. Where there is no Pay-to-Play, the company (and sometimes the lead investors) may try to include a "use it or lose it" provision so that investors who do not fully exercise their Preemptive Rights lose them for future rounds.

TIPS & TRENDS

Acquisitions comprise the vast majority of liquidity events for venture backed companies, including approximately 70% of the amounts raised through all liquidity events since 2013, followed by initial public offerings (~18%), strategic buyouts (~10%) and secondary equity offerings (~2%). In 2018 and the first half of 2019, however, IPOs have taken an outsized share of liquidity events, accounting for approximately 27% of transaction amounts, while M&As have accounted for only about 62% of such amounts over this time period. (See also chart on Page 17)

EXITS TYPES FOR VC-BACKED COMPANIES*



*As of August 22, 2019

MISC. INVESTOR PROTECTIVE PROVISIONS

We finish up our discussion of the Investor Rights Agreement with a quick overview of the remaining provisions, which typically are not the subject of much negotiation.

Non-Competition and Non-Solicitation Agreements – Investors will almost always insist that the company's founders and any other key employees agree not to compete with the company or solicit away any employees, customers or other key business relationships for 1 - 2 years after they leave the company for any reason. Of course, founders/employees have an interest in keeping the term of their restrictions as short as possible, but founders should also realize that as long as they are with the company (and usually they expect to be for a long time) they benefit if former employees are subject to non-compete and non-solicit restrictions for longer terms.

Non-competition and non-solicitation restrictions may be subject to various limitations imposed by the state where the company is headquartered or the employee works. States generally require that these restrictions be reasonably limited with respect to duration and geographic scope, but some states have added additional worker protections. For example, California generally will not enforce any non-competition and/or non-solicitation agreement following an employee's termination from a company and instead encourages employers to rely on non-disclosure agreements to protect trade secrets. In Massachusetts, non-competition agreements must be less than one year in duration and be geographically limited to where the former employee provided services. Additionally, Massachusetts requires that employers pay former employees a "garden leave" payment equal to at least 50% of such former employee's salary for the duration of the non-compete.

Non-Disclosure and Developments Agreement – In any financing with sophisticated investors, the company will be required to ensure that all persons who may have had access to the company's confidential information or a role in the development of the company's intellectual property agree that such information and intellectual property is confidential and belongs to the company.

Board Matters – This provision deals with membership on Board committees, the frequency of Board meetings, obtaining Directors & Officers (D&O) insurance and director indemnification. These matters are typically of little consequence and any issues should be left to the lawyers to hash out when negotiating the final transaction documents. The only thing worth noting is that the company should insist that any indemnification offered to the investors' director(s) is provided to all directors, so that other directors may benefit from this protection as well.

Employee Stock Options – Employee stock options for technology companies typically vest over four years, with 25% of the options vesting after one year and the remaining options vesting monthly or quarterly over the following three years. As we noted in the section discussing the "Nature of a Term Sheet and Summary of Offering Terms," the size of the employee option pool is typically set at around 10 - 20% of the company's fully-diluted capital post-financing, give or take a few percentage points, at the time of a Series A.

Key Person Insurance – Investors often require that the company take out life insurance policies on the founders on the theory that they are the driving force behind the success of the company and their death or disability would dramatically reduce the company's prospects.

RIGHTS OF FIRST REFUSAL AND CO-SALE

While the Investor Rights Agreement deals with the rights of the investors vis-à-vis the company, the Right of First Refusal and Co-Sale Agreement gives the company and the investors certain rights vis-à-vis the company's common stockholders. The principal rights conferred are the eponymous Right of First Refusal ("ROFR" – rhymes with gopher) and Right of Co-Sale (a/k/a "Take-Me-Along" or "Tag Along"), both of which apply to any proposed sale of stock by common stockholders prior to the company's initial public offering.

Right of First Refusal

The NVCA term sheet includes a standard ROFR provision where the company has the first right to purchase shares offered for sale by common stockholders and the investors have the right to purchase any shares the company does not elect to purchase. The ROFR order of priority may be reversed so that the investors' right precedes that of the company. The impact of reversing the order is essentially economic: if an investor purchases shares it pays the purchase price out-of-pocket, so the money doesn't drain the company's coffers, but the investor also increases its ownership interest relative to all other stockholders. A repurchase by the company results in a proportionate increase in the value of shares held by all stockholders.

The NVCA term sheet also gives investors an oversubscription right to purchase a pro rata portion of any shares subject to the ROFR that are not purchased by other investors (this is akin to the Over-Allotment Right that arises in the context of the investors' Preemptive Rights). The oversubscription right is particularly important to investors if, as is often the case, the ROFR must be exercised, collectively by the company and the investors, with respect to all shares proposed to be transferred in order to be given effect. This "all-or-none" restriction on the ROFR is beneficial to selling stockholders, especially those with a large equity stake in the company, because it prevents the company or the investors from dissuading a potential buyer (who may wish to obtain the selling stockholders entire equity stake in the company) by exercising the ROFR with respect to a portion of the shares offered for sale.

Note that in some cases, particularly where there are a number of smaller investors, the ROFR may be applied to the investors as well as the common stockholders. This is generally an inter-investor matter that has little practical significance to the company and the founders.

Right of Co-Sale

Where the ROFR gives investors the opportunity to purchase shares offered for sale, the Tag Along gives them the right to sell their shares (on an as-converted-to-common-stock basis, if necessary) to a purchaser alongside the prospective seller. The Tag Along comes into play to the extent shares offered for sale are not purchased through the ROFR, and it applies pro rata based on the relative ownership interest of the investors and the selling stockholder. As with the ROFR, the Tag Along may be applied to the sale of shares by investors as well as common stockholders, but unlike the ROFR there is never an oversubscription right if certain investors elect not to exercise the Tag Along.

* * * * * * * * * *

Neither the ROFR nor the Tag Along is typically the subject of discussion at the term sheet stage, and there is rarely much negotiation when the transaction documents are drafted. There are, however, a few issues to consider. First, the common stockholders who must become party to the Right of First Refusal and Co-Sale Agreement (and therefore subject to its restrictions) may be limited to a specific group of stockholders (ex. the founders and executive officers) or to stockholders holding at least a minimum percentage of the company's fully-diluted equity ownership (sometimes as low as 1%). The smaller the number of stockholders subject to the agreement, the easier it is to administer; both because the company does not need to require every stockholder to sign the agreement and because not every little transfer will trigger the ROFR and Tag Along. Likewise, where there are a number of small investors it may be beneficial – to the company and to the lead investors – to only give ROFR and Tag Along rights to the larger investors. Again, this eases the administrative burden on the company when the rights are triggered. Finally, both the ROFR and the Tag Along are usually subject to standard exceptions to permit stockholders to transfer shares for limited purposes, such as estate planning. It is also increasingly common to include a "limited liquidity" exception allowing founders to sell a small percentage of their shares without restrictions.

ELECTION OF THE BOARD OF DIRECTORS

The NVCA model Series A financing documents cover two common provisions in the Voting Agreement: (1) the agreement among the stockholders to elect certain individuals to the company's Board of Directors, which we deal with in this section, and (2) the Drag Along, which we cover in the next section.

Election of the Board of Directors

The Board plays a pivotal role in the management of a company because it overseas the company's officers (and has the power to replace them) and because Board approval is required for many corporate actions, including any action that materially impacts the corporation's business. Not surprisingly, then, the composition of a company's Board can be a contentious point of negotiation in a financing.

After a Series A financing, a company's Board will typically consist of three or five directors, with one or two directors elected by the investors, an equal number elected by the common stockholders (including the founders), and one director elected by all of the stockholders voting together. Since the common stockholders often control a majority of a company's voting shares even after a Series A financing, all other things being equal the balance of power on the Board would favor the common stockholders because they would control the election of the last director. Although the right to elect a director or two, combined with the Investor Director Approval provisions, would give investors significant influence over Board decisions, in many instances the investors' director(s) could be outvoted. To exert additional control over the Board, therefore, at the time of a financing investors typically seek to require that the company's common stockholders agree on who will have the right to designate each director, and agree to vote their shares in favor of the election of each designee.

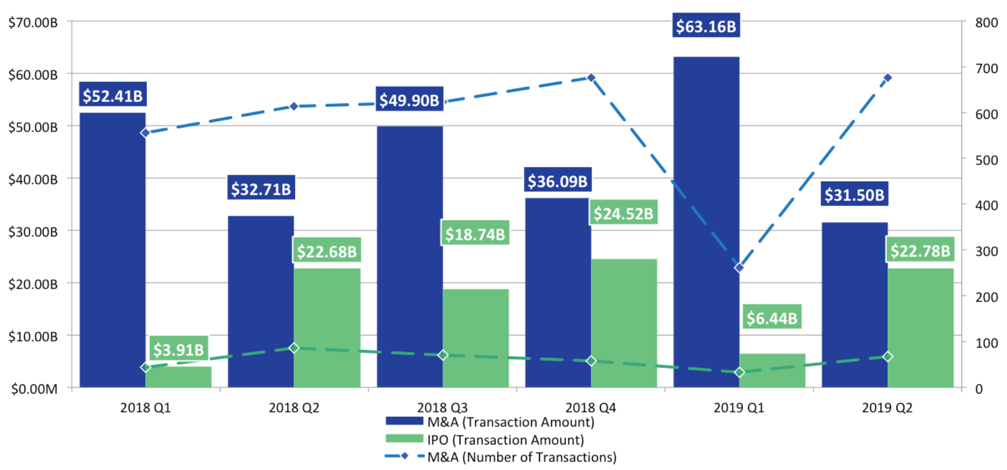
The Board of Directors section of the NVCA term sheet contemplates a typical five-person Board of Directors comprised of two directors designated by the investors, one director designated by the founders, the company's CEO and one "independent" director who is not an employee of the company and who is "mutually acceptable" to the founders and the investors or to the other directors. A three person Board might consist of one investor director, one founder director and one independent. Both of these scenarios enhance the investors' influence over the Board by giving them a say in the selection of directors who they do not have the sole power to elect. First, the investors gain a veto over the selection of the independent director, who otherwise would be selected by a simple majority vote. Second, where the company will have a five-person Board the investors ensure that one of the directors elected by the common stockholders will be the CEO. While the CEO is usually one of the founders at the time of the financing, as a company grows a founder-CEO may be replaced by an outsider who the investors will have considerable influence in selecting (recall that the hiring and firing of executive officers is typically one of the matters requiring approval of the investors' director(s)).

Entrepreneurs should be cautious when negotiating the post-financing composition of the Board with investors. Some investors can add significant value to a company as members of the Board, but you do not want to give up complete control. Seed and angel investors often do not receive the right to elect any directors, and should be offered at most a minority position on the Board. In a venture capital financing in which the investors will own less than 50% of the company following the financing, founders can try to argue that the common stockholders should have the right to designate a majority of the Board (2 of 3 or 3 of 5), but this argument is likely to meet with stiff resistance and could backfire if the investors later come to own more than 50% of the company. Rather, it may be more effective to take steps to ensure the Board composition and decision-making remain as evenly balanced as possible by, for example: (a) requiring that the independent director and any new CEO be approved by unanimous consent of the other directors (which would necessarily include any director designated by the founders; (b) insisting that certain major corporate actions be approved by the director(s) designated by the founders, as well as the director(s) designated by the investors; and (c) if the CEO at the time of the financing is a founder, negotiating an employment contract for the founder-CEO that makes it difficult for the company to terminate her without "cause" (i.e. bad acts by the founder), where "cause" is narrowly defined.

ELECTION OF THE BOARD OF DIRECTORS

There are two other things to keep in mind about the size and composition of the Board. First, in certain states the minimum number of directors required to take a valid action is based on the number of Board seats, rather than the number of directors then elected. If the company is incorporated in such a state, it is important not to create more Board seats than the company intends to fill. Second, while Boards typically consist of an odd number of directors to reduce the likelihood of deadlocks, it may still be beneficial for the company and the investors if the term sheet calls for a tie-breaker provision to be included in the final transaction documents, though the mechanics of the provision are typically not negotiated before the term sheet is signed.

EXITS FOR VC-BACKED COMPANIES



DRAG ALONG

A Drag Along provision (also known as a "Bring-Along") compels a group of stockholders to vote in favor of a transaction approved by another group of stockholders and/or the company's Board of Directors. A Drag Along is most often used to "drag" minority stockholders and can be particularly important in a transaction, such as a merger or a stock tender offer, where approval by all or almost all stockholders may be required. It can also be used, however, to allow a minority of stockholders to drag the majority; which is often the case in the context of a financing where the Drag Along may require most or all stockholders to vote in favor of any Deemed Liquidation Event or other sale transaction approved by the investors.

Venture capitalists typically insist on a Drag Along right because it facilitates a potential exit by preventing the common stockholders from thwarting a sale of the company. The Drag Along is most likely to be exercised if a company is presented with a modest acquisition offer where the common stockholders would receive little or nothing from the transaction after payment of the investors' Liquidation Preference, but it might be exercised anytime the differing business and economic goals and incentives of the investors' and common stockholders cause them to disagree about the merits of a potential acquisition. In such a scenario, the investors want the ability to compel the common stockholders to approve the transaction if the investors conclude it is in their (the investors') best interest. In essence, the Drag Along gives the investors the ability to impose their outlook for the company on the common stockholders.

A Drag Along provision can be a tough pill for founders to swallow, but it has become commonplace (though not universal) in venture deals and is likely to be even more important to investors after the recent economic downturn because they will be extra sensitive to the need for potential exits. There are a number of ways, however, that a standard investor Drag Along right may be modified to make it less draconian. At the term sheet stage, the primary means of softening the Drag Along right are: (1) providing that exercise of the right requires a vote of all stockholders, not just the investors; (2) setting a higher threshold for such a vote (the threshold typically ranges from a majority to 67% of the stockholders entitled to vote); and (3) providing that approval of the company's Board of Directors is also required to trigger the Drag Along (but recall from the section on "Election of the Board of Directors" that investors can have significant influence on the Board). Other limitations on the Drag Along, usually negotiated by the lawyers during the drafting of the transaction documents, may restrict the terms and conditions of a transaction in which the Drag Along is exercised.

Note that if the investors agree to require a vote of all stockholders to trigger the Drag Along, the threshold should not be set so high as to allow a small group of common stockholders to thwart a transaction.

Finally, note that the "Sale Rights" provision of the NVCA term sheet is essentially an extension of the Drag Along specifying the procedure the company would undertake if the requisite group of stockholders desires to sell the company.

VESTING OF FOUNDERS' STOCK

Investors often want at least a portion of the stock owned by each founder of a company to be subject to vesting and a corresponding company buyback right if the founder ceases to be employed by the company within a certain period of time after a financing (the "vesting period"). The purpose of the buyback is to incentivize the founder to continue working for the company until the end of the vesting period (when a new equity incentive grant is usually made). This benefits not only the investors, but also the other stockholders (including the other founders) because shares repurchased by the company upon the departure of a founder will proportionately increase the value of all remaining shares.

The standard vesting term for equity incentive grants in an early stage company, such as options granted to employees, is four years, with 25% of the grant vesting after one year (this is called a "cliff") and the remainder vesting monthly or quarterly over the remaining three years. The NVCA term sheet's "Founders' Stock" provision follows this basic formula for the vesting of founders' stock. If, however, the founders have worked for the company for a reasonable period of time before the financing (typically a year or more before a Series A financing), investors are often willing to exempt a portion of each founder's shares from vesting (usually up to 25%), while allowing the remainder to vest monthly over three to four years (with no cliff). In addition, founders are often able to negotiate for full or partial acceleration of vesting if (a) the founder quits for "good reason" (generally defined as actions by the company that adversely affect the founder's employment), (b) the company fires the founder *without* "cause" (generally defined as bad acts by the founder) or (c) the company is acquired. In the case of an acquisition, acceleration may apply upon the occurrence of the acquisition (called "single trigger" acceleration) or only if the founder's employment is terminated (usually *without cause* or *for good reason)* within a certain period of time after the acquisition (called "double trigger" acceleration). The specifics of accelerated vesting – including the definitions of "cause" and "good reason" and the choice of single or double trigger acceleration – are typically negotiated during the drafting of the transaction documents rather than at the term sheet stage.

It is also important to understand the extent of the company's buyback right. The company will always have the right to repurchase any unvested shares from a founder if the founder's employment terminates for any reason (typically at the price the founder paid for such shares), but some investors may also want the company to have the right to buy back *vested* shares (typically at a price equal to the fair market value of the company's common stock at the time of termination). Founders should strongly resist giving the company the right to buy back vested shares under any circumstances, but founders sometimes agree to allow the company to buy back vested shares upon termination *for cause* in exchange for acceleration of vesting if the founder's employment is terminated *without cause* or *for good reason.*

NO SHOP AND CONFIDENTIALITY

In the first section of this pamphlet, we noted that the No Shop/Confidentiality provision is one of the two provisions in the term sheet that is usually "binding" on the company and the investors – meaning it is enforceable even if the rest of the contemplated financing is never completed. It is also the last provision of the NVCA term sheet we will cover as the other two provisions – "Existing Preferred Stock" and "Expiration" – are not negotiated terms.

The implications of the both portions of the No Shop/Confidentiality provision are straightforward. The "No Shop" portion requires the company to refrain from actively pursuing any other investment or any sale of the company for a set period of time after the term sheet is signed. The "Confidentiality" portion prohibits the company from disclosing the terms of the term sheet, except on a need-to-know basis. Most of the time the only point of negotiation is the length of the No Shop period. This ranges from 30 to 90 days, but is typically 45 or 60 days (in our experience). If the No Shop is shorter than 45 days, there's a good chance it will expire before the transaction closes. A No Shop greater than 60 days allows the transaction to drag on too long. Once the term sheet is signed, both sides are usually anxious to get the transaction closed as quickly as possible.

Note that the NVCA term sheet includes an optional "break-up" fee in the event the No Shop provision is breached, but also notes that including such a fee is uncommon and generally only used in later-stage financings.

KEY TAKEAWAYS AND OTHER RESOURCES

In the introduction to this pamphlet we said that our goal was to give readers the ability to better evaluate financing term sheets. We sincerely hope we've been able to shed at least a little light on the subject and we welcome your questions on any topic that is still a mystery. We close with a summary of the most important points we've covered and a list of other great online resources for information about financing and other subjects important to entrepreneurs and startups.

Key Takeaways

1. Broadly speaking, the main areas of negotiation between entrepreneurs and investors are: (a) economics of the investment – valuation, dividends, liquidation preference, anti-diultion and redemption rights; and (b) control of the company – voting and protective provisions, composition of the Board, preemptive rights, pay-to-play, drag-along and vesting of founders' stock.

2. In addition to valuation, dividends and liquidation preference can have a significant impact on the relative economic rights of the founders and the investors. It is important to understand the interplay among these provisions when evaluating proposed terms.

3. The employee option pool should be sufficient to satisfy the company's need to incentivize employees and other service providers for the foreseeable future. Be sure to understand whether the option pool is included in the pre- or post-money valuation and how this impacts the economics of the transaction.

4. Obtaining approval for corporate actions from the directors designated by the investors is procedurally much simpler than obtaining consent from the investors themselves. Ideally, investors should only get a separate stockholder vote on major corporate actions, such as a sale of the company.

5. Full ratchet anti-dilution is very investor favorable; weighted average anti-dilution is more common.

6. A Pay-to-Play can help mitigate the negative impact of anti-dilution protections in a down-round financing.

7. If the company is paying the investor's legal fees, try to include a cap on those fees in the term sheet.

8. Don't try to negotiate-away the investors' Registration Rights, but do try to include Registration Rights for the founders.

9. Preemptive Rights should not preclude the company from raising money from new investors.

10. A company's Board of Directors has significant control over its business, so it is important to understand how the composition of the Board and the process of designating directors impact the balance of power between the founders and the investors.

11. It is important to try to negotiate limits on an investor Drag-Along to prevent the founders and other common stockholders from being forced into a fire-sale.

12. If founders' stock will be subject to vesting following the financing, a portion of the founders' shares should be vested immediately to account for time-served and founders should seek to have the remainder vest monthly over no more than three years.

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KEY TAKEAWAYS AND OTHER RESOURCES

Other Resources

We are hardly the first to try to distill investment terms. Here are a few other excellent resources with great information on financing terms and other matters relevant to entrepreneurs and startups:

1. Brad Feld:
   feld.com/archives/category/term-sheet

2. Startup Lawyer (Ryan Roberts):
   startuplawyer.com/category/venture-capital

3. Startup Company Lawyer (Yokum Taku):
   startupcompanylawyer.com/category/series-a

4. Venture Hacks:
   venturehacks.com

5. NextView Ventures:
   http://nextviewventures.com/blog/category/fundraising/

6. Mark Suster:
   https://bothsidesofthetable.com/tagged/venture-capital

7. Fred Wilson:
   http://avc.com/

Benjamin M. Hron // Boston
Partner

T: 617.449.6584
F: 617.326.3074
bhron@mccarter.com

Ben Hron is a business law attorney whose practice focuses on representing companies on general corporate matters, debt and equity financing, mergers and acquisitions, securities law compliance and joint ventures. Ben also represents private equity and venture capital funds, angel investors and financial institutions in connection with the financing of public and private companies.

Ben serves as outside general counsel for a number of his clients, advising company management on legal issues ranging from day-to-day matters to large strategic initiatives. He also coordinates and supervises the work of experts in other practice areas when appropriate. In addition to working with established companies, Ben has extensive experience working with entrepreneurs and startups, often getting involved when a business is still in its infancy and helping guide the founders through the formative early stages of their company's development. The experience of co-founding and growing his own law firm, VC Ready Law Group, from 2009 to 2011 has helped Ben better understand and address the issues facing many of his clients.

As counsel to investors and financial institutions, Ben helps structure and negotiate debt and equity financing transactions, including venture capital, growth capital, asset-based loans and distressed debt workouts. He also frequently writes and lectures on the laws and regulations governing financing transactions and recent trends in deal terms.

Ben was co-chair of the Securities Law Committee of the Boston Bar Association from 2013 to 2015 and co-chair of the BBA's Venture Capital and Emerging Companies Committee from 2015 to 2017. From 2011 to 2017, Ben hosted the McCarter & English seminar series for entrepreneurs at the Cambridge Innovation Center.

Ben received a Juris Doctor from Harvard and a Bachelor of Arts (magna cum laude) in Biology and Political Science from Carleton College. He is admitted to practice law in Massachusetts.

Other Publications

The State of Venture Capital in 2017

The New Rules for Raising Capital from Accredited Investors

JOBS Act Updated: SEC Proposes Rules to Facilitate General Solicitation for Offers of Securities Under Rules 506 and 144A

Crowdfunding Traps for the Unwary

JOBS Act Opens New Avenues to Capital for "Emerging Growth Companies

Will Crowdfunding Really Pay Off for Startups?

Stephen Fox // Boston
Associate

T: 617.449.6581
F: 617.607.9309
sfox@mccarter.com

Stephen Fox advises emerging companies and investors throughout the corporate life cycle, including pre-incorporation planning and formation, venture capital financings, mergers & acquisitions, and general corporate representation and counseling. He delivers smart solutions for clients in industries including life sciences, technology, and blockchain.

He has represented early- to growth-stage private companies, angel, venture capital, and strategic investors in equity and debt financings, and both sellers and buyers in complex mergers, stock and asset acquisitions, and a variety of M&A exits.

Stephen graduated from Boston University School of Law and was a member of the Boston Bar Association's Venture Capital and Private Equity Conference Advisory Committee.

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.

TERM SHEET

Preliminary Note

This term sheet maps to the NVCA 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).

TERM SHEET
FOR 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]

<u>Offering Terms</u>

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**").

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[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.

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.]
Liquidation Preference:	In the event of any liquidation, dissolution or winding up of the Company, 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

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.

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]

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

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[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).

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."

Anti-dilution Provisions: 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

[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.

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)].

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

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[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 <u>Subsections 4.4.1(d)(v)-(viii)</u> 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.

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] [Representations and warranties regarding CFIUS.][17]

[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 particulary 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

[*Regulatory Covenants (CFIUS):*	*To the extent a CFIUS filing is or may be required:* Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("**CFIUS**") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]][18] [Notwithstanding the previous sentence, Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors' right to exercise control over the Company.][19]
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, [the obtaining of CFIUS clearance and/or a statement from CFIUS that no further review is necessary,] [20] 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

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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] To be considered in order to address issues under the Defense Production Act of 1950 and related regulations (DPA). Relevant representations may include whether or not a Company works with "critical technologies" within the meaning of the DPA, whether a Company has operations or activities in particular sectors of the U.S. economy or in the U.S. at all, whether an Investor is foreign, and whether an Investor has foreign government relationships, among others.

[18] To be included if Investors review the facts of the investment and determine that a CFIUS filing is warranted. When the Investors are foreign persons, a CFIUS filing may be mandatory with respect to certain investments (e.g., some transactions involving "critical technologies") and voluntary but advisable with respect to others. This covenant may be paired with an explicit reference to the exercise of the redemption right in the charter in the event of a CFIUS-mandated divestiture of shares. A CFIUS "notice" is a full-form filing that results in a definitive opinion by CFIUS regarding the national security risks associated with the transaction but may take months to obtain; a CFIUS "declaration" is a short-form filing that may not result in a definitive opinion by CFIUS but is intended to be able to be obtained within 45 days.

[19] If a CFIUS filing is warranted, the parties may also elect to negotiate a basic statement laying out the scope of Investors' obligation to accept CFIUS conditions. Whether or not a CFIUS filing is made, the parties may wish to consider other risk allocation measures; examples include unilateral or bilateral waivers of responsibility for CFIUS-related costs and penalties, indemnification terms, or other similar language.

[20] To be included if Investors review the facts of the investment and determine that a CFIUS filing is warranted. Note that in cases where a mandatory filing is necessary, that filing must be submitted 45 days in advance of closing, but obtaining CFIUS clearance in advance of closing is not a requirement of law. However, submitting a CFIUS filing and then closing over that review process creates regulatory risks for Investors that are best avoided if the timing of the investment permits.

Investors withdraw their commitment without cause].[21]

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**."[22]

Demand Registration: Upon earliest of (i) [three-five] years after the Closing; or (ii) [six] months[23] 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).

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

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21 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.

22 Note that Founders/management sometimes also seek limited registration rights.

23 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.

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][24] 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.

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.[25]

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

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[24] See commentary in footnotes 23 and 24 of the Model Investors' Rights Agreement regarding possible extensions of lock-up period.

[25] See commentary in introduction to Model Managements Rights Letter, explaining purpose of such letter.

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.

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];[26] (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,

[26] 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.

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:[27]	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.
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.]
[*Limitations on Pre-CFIUS-Approval Exercise of*	Notwithstanding anything to the contrary contained in the Transaction Agreements, Investors and the Company agree that as of and following the initial Closing and until the CFIUS clearance is

[27] 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.

Rights:	received, Investors shall not obtain (i) control (as defined in 31 C.F.R. § 800.204) of the Company, including the power to determine, direct or decide any important matters for the Company; (ii) access to any material nonpublic technical information (as defined in 31 C.F.R. § 801.208) in the possession of the Company (which shall not include financial information about the Company), including access to any information not already in the public domain that is necessary to design, fabricate, develop, test, produce, or manufacture Company products, including processes, techniques, or methods; (iii) membership or observer rights on the Board of Directors of the Company or the right to nominate an individual to a position on the Board of Directors of the Company; or (iv) any involvement (other than through voting of shares) in substantive decisionmaking of the Company regarding the use, development, acquisition, or release of any of the Company's critical technologies (as defined in 31 C.F.R. § 801.204). To the extent that any term in the Transaction Agreements would grant any of these rights, (i)-(iv) to Investors, that term shall have no effect until such time as the CFIUS clearance is received.] [28]
[*Springing CFIUS Covenant:*	[In the event that CFIUS requests or requires a filing/in the event of [ ]], Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("**CFIUS**") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]. Notwithstanding the previous sentence, Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors' right to exercise control over the Company.][29]
[*Limitations on Information Rights:*	Notwithstanding anything to the contrary contained in the Stock Purchase Agreement, the Charter, the Investors' Rights Agreement, the Right of First Refusal And Co-Sale Agreement, and the Voting Agreement (all of the agreements above together being the

[28] To be included if Investors intend to close the transaction in stages, with at least one stage occurring before CFIUS clearance is obtained. The foreign investor side letter language on point would override any aspect of the other transaction agreements that might grant control of the Company or access to aspects of the Company that might create grounds for CFIUS jurisdiction – until CFIUS clearance is obtained.

[29] To be included if Investors believe that there is risk that CFIUS may request a filing of the transaction at some future date or that a CFIUS filing may be required in the event of some future event (e.g., when the exit of another investor causes Investor to obtain control over the selection of a board member). A springing CFIUS covenant provides certainty that all parties will proceed at CFIUS in orderly fashion. The further "notwithstanding" sentence ensures that while parties will cooperate to make the CFIUS filing, Investor will not be obligated to accept CFIUS-required conditions on the deal that might frustrate the purposes of its investment (i.e., the Investor can abandon the proposed investment); more robust mitigation commitment language may be desirable from the perspective of U.S. companies or U.S. investors seeking to limit foreign investors' ability to abandon the transaction. For more information on the differences between electing to pursue a CFIUS notice vs. a CFIUS declaration and considering a reference to redemption rights, please see note 18, above.

"**Transaction Agreements**"), Investors and the Company agree that as of and following [Closing/the initial Closing], Investors shall not obtain access to any material nonpublic technical information (as defined in 31 C.F.R. § 801.208) in the possession of the Company (which shall not include financial information about the Company), including access to any information not already in the public domain that is necessary to design, fabricate, develop, test, produce, or manufacture Company products, including processes, techniques, or methods.] [30]

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.[31]

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

30 To be included if Investors are considered foreign entities under the DPA and intend to make an investment outside the jurisdiction of CFIUS. Note that this assumes that Investors intend not to obtain (i) a board seat, observer, or nomination right, (ii) more than 10% of the voting rights in the Company, or (iii) control over decision-making at the Company, including with respect to company technologies. If the Stock Purchase Agreements, Charter, and other Transaction Agreements contemplate an investment on those terms, then a disclaimer of information rights with respect to certain technical information should be the last necessary step to remove the transaction from CFIUS jurisdiction. Further markups of the other Transaction Agreements would be necessary to ensure that they are developed consistent with this intention.

31 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.

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.][32]

[*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.][33]

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:*[34] 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

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32 See Subsection 3.3 of the Model Voting Agreement for a more detailed list o f conditions that must be satisfied in order for the drag-along to be invoked.

33 See Addendum to Model Voting Agreement

34 Necessary only if this is a later round of financing, and not the initial Series A round.

	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.][35] 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[___].

[SIGNATURE BLOCKS]

[35] 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).

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				