UNDERSTANDING TERM SHEETS

AN OVERVIEW OF KEY PROVISIONS INCLUDED IN INVESTMENT PROPOSALS MADE BY VENTURE CAPITAL OR PRIVATE EQUITY INVESTORS IN PRIVATE COMPANIES

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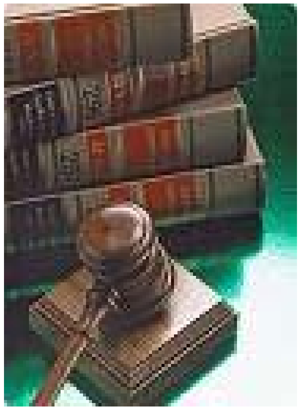
A term sheet is the foundation of a contemplated investment

- Term sheets serve as an expression of intent given to a company seeking investment. The document outlines the proposed terms for an investment transaction between two parties
- Term sheets serve two primary functions
  - Summarizes all important financial and legal terms related to a contemplated transaction
  - Quantifies the amount of the transaction financing and the value of the company's securities prior to the financing
- If terms are agreed to, the term sheet serves as the basis by which to draft the legal documents surrounding the contemplated purchase of securities
  - Term sheets can address either the purchase of existing shares (secondary issuance) or the purchase of newly created shares (primary issuance), or both
- Usually written by lead investor, the term sheet will serve as a framework for other investors

Term sheets guide and convey commitment, but are non-binding



- A term sheet is not technically a binding legal document
- As a matter of contract law, both parties have an implied duty to negotiate in good faith
- Often, term sheets include an exclusivity clause
    - Once accepted, forbids solicitation from other investors for a stated period of time – typically 45 to 90 days
- During the drafting process, the term sheet acts as a guideline for the lawyers to draft:
    - Purchase and Sale Agreements (PSAs) which new investors will sign
    - Amendments to the company's charter
    - Any changes which impact powers of existing shareholders must be agreed to by these shareholders and directors before financing can proceed
- Certainty of close after execution of a term sheet depends on the level of due diligence completed prior to its execution, and the commitment level of each party to the transaction

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Term sheets are dynamic

- Terms and conditions vary greatly
  - Number of interested investors
  - Competition and industry
  - Caliber of the management team
  - Goals of investor
- Term sheets are typically anywhere from 8-20 sections
- Depending on the investor's partnership structure, investment horizons are typically 3-7 years
  - Directly impacts milestones that company must meet

I. Overview of Term Sheets

II. Key Issues

III. Composition of a Term Sheet

Valuation, control and security structure are areas of primary concern

- Price per Share
    - Embodies economic value of the company today
- Current Securities
    - Description and number of shares in each class of stock existing before new round
    - Summary of capital structure
    - Includes options and warrants
    - Pre Money Value = (Shares + Options + Warrants) x Price per Share
    - Post Money Value = Pre Money Value + Amount Raised
- Board of Directors / Special Board Approval
    - How will the company be managed in critical circumstances?
        - Taking on debt
        - Making significant management hires
        - M&A / IPO
    - Who are the directors? What classes of stock do they own?
- Options
    - Dilution
    - Do founders want to participate in employee options?

Companies need to be wary of constraints

- Under-financing
  - If further financing is required, does it make sense to stage financing based on anticipated valuation increases, or "raise all the capital you need" in one tranche?
  - May depend on assessment of future capital markets and track record of investor in supporting portfolio companies
- Limiting the syndicate
  - Some investors may want to limit other investors' involvement
    - Could be to maximize control
    - Diversity could facilitate future rounds of financing
    - However, not all investors get along

- Milestones
  - What are the consequences of failing to meet performance metrics?
    - Can result in triggering a conversion ratio which gives the investor more control/reduces ownership of founders
    - Accrued dividends may be viewed as one form of trade-off relative to investment milestones

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I. Overview of Term Sheets

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- Preamble (may or may not be present)
  - Specifies time a term sheet will remain in effect – intended to motivate dialogue and prevent investee from “shopping” the term sheet
  - Non-solicitation mandates, if any
- Opening Information
  - Fairly standard, it introduces an overview of the transaction, name of company and name of investor

This memorandum summarizes the principal terms of the Series A round venture capital financing of ABC Corporation (the “Company”). The company was incorporated in Texas on March 1, 1993.

Investors	Texas Capital (“Investor”)

- Critical that company understands different classes of securities
- Companies typically sell convertible preferred stock to investors
  - Provides a preference payment (over founder or common stock) to the preferred stock in the event the company is acquired or liquidated
  - Gives shareholder right to convert into common at some point or under certain circumstances
    - Dictates ownership based on number of common shares
    - Usually upon exit or change of control, when the value of the preferred securities on an as-converted to common basis exceeds the value of the liquidation preference, then the securities are converted to common
  - This liquidation preference makes the preferred securities more valuable than common stock at a given value of the company
- Total Amount Raised
- Number of Shares
- Price per Share

Self explanatory

- Post-Financing Capitalization
  - Summarizes capital structure after proposed financing

	Shares	%
Common Stock	2,500,000	29%
Option Pool	1,000,000	12%
Total pre-financing	3,500,000	41%
Series A Preferred	5,000,000	59%
Total Post Financing	8,500,000	100%

- Stock Option Plan
  - Prior to the closing, the company will adopt a customary stock option plan (or amend its current plan), which will be in a form acceptable to new investors, management, prospective employees, non-investor directors and consultants
- Common Stock Vesting
  - Outlines vesting structure or restrictions on sale of stock

Stock Option Plan 1,000,000 shares of common stock will be reserved for issuance under this plan, equal to approximately 12% of the Company after the Closing on a full-diluted post-financing basis.

Common Stock Vesting All stock and stock equivalents issued after the Closing shall be subject to vesting as follows: 25% after one year from the date of closing and remaining 75% will vest monthly for the next three years thereafter.

The economic effect of dividends can be significant over 3-7 years

- Allows investors to protect their investment
- Typically, dividend rates range from 6-12%, varying somewhat to match prevailing interest rates
- Dividend Preference
  - Generally, a dividend must be paid to the preferred stockholders before common
  - Can be cumulative (accrues from year to year until paid in full, usually upon sale or liquidation)
  - Typically discretionary at Board's decision
- 3 Example Scenarios

Scenario	Return	Cum/Non-Cum	Board Approval
Pro Investor	>=10%	Cumulative	Discretionary
Balanced	8%	Cumulative	Discretionary
Pro Company	<=8%	Non-Cumulative	Discretionary

Participating Preferred Securities are pro investor

- Allows for favorable treatment of investor in the event of a liquidation
- No Participation
- Participating Preferred stock
  - Not only does the investor receiving preferred return, but then also will participate in some manner with the common stock upon further distribution
- Capped Participating Preferred
  - Creates ceiling on the amount preferred shareholders can participate in
  - Limits extra benefit received to a fixed amount
  - Can be fixed as a price or multiple of the original investment
  - Once preferred shareholders receive this amount, they stop participating
- Defining "liquidation" is standard format

Participating Preferred First, the Series A Preferred shall have a liquidation equal to the original purchase price per share, plus accrued dividends on each share, the balance of the proceeds to be paid ratably to Series A Preferred and Common on an as-converted to Common Stock basis.

Capped Participating Preferred First, the Series A Preferred shall have a liquidation equal to the original purchase price per share, plus accrued dividends on each share. Thereafter, the holders of Series A Preferred Stock and Common Stock shall share proceeds on a pro rata (as converted) basis until the holders of Series A Preferred Stock have received [3x] cost. Thereafter, balance of proceeds paid to Common Stock.

Standard Format
A consolidation or merger of the Company or sale of all or substantially all of its assets shall be deemed to be a liquidation or winding up for purposes of the liquidation preference.

Redemption secures investors an exit for their investment

- Preferred stock may be redeemable at either company or investor's option or mandatorily at a specified date, usually at some premium over the proposed price
- Purpose of redemption is provide a structure which ensures that investors can exit the investment by putting a finite number of years on the life of the investment
- Preferred can require company to redeem greater of original purchase price plus any accrued or unpaid dividends or current fair market value
- Alternatives
  - Non-Redeemable
  - Fair Market Redemption - Shares usually become redeemable over a multi-year period beginning 5 years from date of closing
  - Company Forced Fair Market Redemption – Pro company, but very rare
  - Dividend Redemption – Shares are redeemable at original purchase price plus the payment of a dividend equal to specified rate of return, compounded annually

Redemption At the election of the holders of at least [2/3] of the Series A Preferred, the Company shall redeem the outstanding Series A Preferred in three equal annual installments beginning on the fifth anniversary of the Closing. Such redemptions shall be at a purchase price equal to the Original Purchase Price plus declared and unpaid dividends.

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Conversion facilitates an IPO process

- Enables preferred shareholders to convert in the event of a liquidity event that is likely to generate a return greater than the multiple mandated in the Liquidation Preference section
- Typically expressed as the initial purchase price of the preferred stock divided by a "conversion price"
- Conversion price initially equals the purchase price but is subject to adjustment upon certain events
- Voluntary Conversion
  - Holders will have the right, at any time, to convert shares of preferred into common
- Automatic Conversion
  - Purpose is to immediately prepare and simplify company's capital structure before an IPO
  - Assumes a specified rate of return or IPO size (depending on industry) necessary to force conversion

Automatic Conversion The Series A Preferred shall be automatically converted into Common Stock, at the then applicable conversion price, (i) in the event that the holders of at least two thirds of the outstanding Series A Preferred consent to such conversion or (ii) upon the closing of a firmly underwritten public offering of shares of Common Stock of the Company at a per share price not less than [3 times] the Original Purchase Price per share and for a total offering with net proceeds to the Company of not less than $50 million (a "Qualified IPO")

Antidilution protects the investor against future "down" rounds

- It is important for companies to consider how future rounds of financing will affect existing shareholders
- The conversion price of preferred stock will be subject to adjustment for dilution events such as stock splits or stock dividends
- Dilution clauses are important in the event of a future round of financing at a price lower than the previous price (down round)
- Price protection provisions adjusts future sales of stock at prices below the conversion price

Antidilution Provision The Series A Preferred Stock shall be entitled to proportional antidilution provisions for stock splits, stock dividends, etc. In addition, the Investors shall have standard weighted average anti-dilution rights in the event that the Company issues additional equity securities at a purchase price less than the applicable conversion price.

Types of Anti-Dilution Provisions

- No Dilution
  - Adjustments for dividends, splits and recaps only, rarely used
- Weighted Average
  - Narrow-Based Weighted Average
    - Investor friendly alternative which adjusts downward more rapidly than the broad-based version
  - Broad-Based Weighted Average
    - Company friendly alternative
    - Broad-based means that in calculating the price to which an existing series converts, the outstanding shares of Common Stock are treated as though they were sold at the same price as the series being adjusted, thereby lessening the impact of a down round
- Full Ratchet
  - Pro investor, but very rare – usually used with companies in financial distress
  - Lowers the conversion price to the price at which any new stock is sold, no matter the number of shares
  - Downside of receiving a high pre-money valuation – increases likelihood of next round being flat or down
  - Full ratchet provisions work to the detriment of common shareholders who get diluted
- Other
  - Pay to Play - Converts at a weighted average basis as long as investor purchases a full pro rata share of dilutive issuance

EXAMPLE – ANTI-DILUTION

Anti-Dilution Provision Analysis

	Before Preferred B	No Anti-Dilution	Weighted Average	Full Ratchet Average
Assumptions				
Pre Money Value of Company	$ 3,000,000	$ 3,000,000	$ 3,000,000	$ 3,000,000
Existing shares of Common Stock	3,000,000	3,000,000	3,000,000	3,000,000
Plus: Preferred A Investment	$ 1,000,000	$ 1,000,000	$ 1,000,000	$ 1,000,000
Post Money Value of Company	$ 4,000,000	$ 4,000,000	$ 4,000,000	$ 4,000,000
Conversion Price of Preferred A	$ 1.00	$ 1.00	$ 0.88 (1)	$ 0.50
Preferred Series A Common Equivalent	1,000,000	1,000,000	1,142,857	2,000,000
Plus: Preferred B Investment	$ -	$ 500,000	$ 500,000	$ 500,000
Conversion Price of Preferred B	$ -	$ 0.50	$ 0.50	$ 0.50
Preferred Series B Common Equivalent	-	1,000,000	1,000,000	1,000,000
Common Stock Breakdown				
Preferred A	1,000,000	1,000,000	1,142,857	2,000,000
Preferred B	-	1,000,000	1,000,000	1,000,000
Common	3,000,000	3,000,000	3,000,000	3,000,000
Total	4,000,000	5,000,000	5,142,857	6,000,000
Ownership				
Preferred A	25%	20%	22%	33%
Preferred B	0%	20%	19%	17%
Common	75%	60%	58%	50%
Total	100%	100%	100%	100%
Accretion (Dilution)				
Preferred A	NM	-5%	-3%	8%
Preferred B	NM	-5%	-6%	17%
Common	NM	-15%	-17%	-25%

(1) Calculation of Weighted Average Price per Share

Preferred A conversion price per share	$ 1.00
Market value of Preferred B investment	$ 500,000
Shares of Preferred B Stock	1,000,000
Common Equivalent of Preferred B at Preferred A price	500,000
Existing shares of Common Stock	3,000,000
Plus: Common Equivalent of Pref. B at Pref. A price	500,000
Total (a)	3,500,000
Existing shares of Common Stock	3,000,000
Plus: Shares of Preferred Stock	1,000,000
Total (b)	4,000,000
Total (a) / Total (b)	0.8750
x Preferred A conversion price per share	$ 1.00
Weighted Average Price per Share	**$ 0.88**

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Preferred investors usually negotiate for "protective" provisions

- Typically, voting rights are the same for all classes of securities based on a common stock equivalent basis
- However, preferred investors typically get protective provisions which grant them additional rights
  - Stipulated actions require consent of some proportion (typically one-half or two-thirds) of these shareholders
    - Altering or changing the preferences, privileges or rights of preferred stock
    - Issuing new classes of equity securities, other than employee stock
    - Engaging in new businesses
    - Increasing or decreasing authorized number of directors on the Board
    - Any consolidation, sale or merger
    - Amending the company's by-laws
    - Redeeming, repurchasing or declaring a dividend
  - If used properly, protective provisions are an element of good governance and can ensure consistent communication among board members and different classes of shareholders

BOARD REPRESENTATION

- Dictates the authorized number of directors (typically 3 to 7) and the number of directors that the investors have the right to elect
  - Usually depends on percentage of shares investors hold after closing and how they are elected
- Special Board Approval Items
  - May or may not be included
  - Could represent issues of control
    - Board approval for hiring officers of the company or senior management
    - Assumption of debt
    - Employment agreements
    - Budgets, business plans and financial plans

Board Composition The size of the Company's Board of Directors shall be set at 5. The Board shall initially be composed of… At each meeting for the election of directors, the holders of the Series A preferred, voting as a separate class, shall be entitled to elect two members, and the remaining directors will be mutually agreed upon by the Common and Preferred. It is anticipated that the Company's CEO will occupy one of the remaining seats. Board of Directors' meetings will be held at least four times per year.

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- Information Rights define the extent to which investors are given access to information in a company
- Generally, a timeframe is identified during which the investor will have rights to information
  - Inspect premises
  - Monthly or quarterly financial statements
  - Budgets
  - Management's discussion on the business
- Extreme, but rare measures
  - Forensic audits
    - Investors can examine all audited or unaudited documents, financial or otherwise, that may exist in a company's files or accounting software
  - Observer rights
    - Ability to sit in on board meetings and have access to information at the board level
    - Does not mean right to vote, but presence has potential to impact decisions

Information Rights So long as the Investor holds at least 1,000,000 shares of Series A Preferred Stock, the Company shall deliver to the Investor audited annual financial statements, audited by a Big Four accounting firm, and unaudited quarterly financial statements. In addition, the Company will furnish the Investor with a copy of the Company's annual operating plan within 30 days prior to the beginning of the fiscal year. Each Investor shall also be entitled to standard inspection and visitation rights.

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- Registration Rights section stipulates the extent to which preferred versus common stock will share equal or preferential treatment when their securities have been converted and are participating in a public offering
- Investors have the right to “demand” a registration of their securities upon filing of an IPO
  - Typically dictated by a specified percentage of investors within a specified period of time
  - Virtually never exercised however
    - Investment bankers would not take a company public whose management or Board resisted the idea
- These rights can be renegotiated at time of IPO, but will ultimately depend on
  - Influence of the investor
  - Nature of financial markets at time of IPO
  - Influence of underwriter
- Variables
  - Number of registrations that the company is obligated to effect
  - Period of time in which these registrations are required
  - Economic cost of registration (i.e. does the company or the shareholder pay)
- Piggyback Registration Rights
  - Standard clause which allows existing shareholders to sell stock in combination with new public shares
  - Usually subject to pro rata cutback on number of shares they can register (depends on industry and reflects what investment bankers would allow)

- Termination of Registration Rights
  - Typically expire between 3 and 7 years after IPO or when all shares can be sold in a smaller offering
  - Provides the company with a means to rid accumulating pile of registration rights which must be waived in the event of new round of financing
- Transfer of Rights
  - Specifies who may receive rights in a transfer, typically partners, family members and other large shareholders
- Standoff Provision
  - If requested by underwriters, this optional clause prohibits sale of shares within a specified time after IPO (often 180 days)
  - Investors are generally against this

- Preemptive Right for Purchase of New Securities
  - Gives preferred stockholders chance to play in future rounds by granting them a preemptive right (right to maintain ownership percentage)
- Right of First Refusal
  - Forces company to first make and have a accepted a contingent third party offer, which would then have to be offered to existing investors who could simply step in at the offered price
  - Effectively gives investors ability to influence sale of future stock
  - Less favorable to company
- Typically these rights are not granted to common shareholders, including employee stock compensation

Preemptive Right for Purchase of New Securities The holders of Preferred Stock shall have the right in the event the Company proposes to offer equity securities to any person (other than the securities issued pursuant to employee benefit plans or acquisitions) to purchase on a pro rata basis all or any portion of such shares. Any securities not subscribed for by an Investor may be reallocated among the other Investors. If the Investors do not purchase all of the securities, that portion that is not purchased may be offered to other parties on terms no less favorable to the Company for a period of 60 days.

Conditions precedent should be reasonable in scope and complexity

- Not always included in a term sheet
- Presents a roadmap to the completion of financing proposed by the term sheet
- Details due diligence that must be completed once the terms have been agreed to
- Highlights that a round of financing will not be complete until final Purchase and Sale Agreements have been signed by prospective investors
- Can also require that certain business conditions (including the hiring of key personnel) be met prior to the transaction closing
- Companies should seek to limit these conditions to items that are highly achievable in the state time frame prior to closing – otherwise, the company may face needless expense and/or be placed in an inferior negotiating position

EMPLOYEE MATTERS

- Outlines option pool for employees, vesting schedule and restrictions on sales of stock
- Key Man Insurance
  - More typical in early rounds of financing, where the loss of one or more key individuals could spell the end of the company

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Items such as legal and closing expenses should not be underestimated

- Closing Date
  - Needs to reflect a realistic period of time in which to draft legal documents – timeframe often designed to match the exclusivity period if applicable
  - Typically 60-90 days
- Legal Counsel
  - Companies should not underestimate the importance of selecting experienced transaction counsel
  - Legal counsel should have experience in evaluating term sheets and drafting purchase and sale agreements
  - If investors are purchasing a first round of preferred stock, it is reasonable to let investor's counsel take the lead
- Expenses
  - Can add up when multiple law firms are involved, particularly for smaller financings – reasonable to negotiate an expense cap on legal as well as due diligence expenses
  - Common for expenses of investors' legal counsel to be paid by company as a consequence of contemplated transaction