

2014

Advising Venture & Early-Stage Client: Issues Confronting Early-Stage Companies

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Repository Citation

Hurst, Carroll D., "Advising Venture & Early-Stage Client: Issues Confronting Early-Stage Companies" (2014). *William & Mary Annual Tax Conference*. 707.

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William & Mary Tax Conference
November 7, 2014
Advising Venture & Early-Stage Client
Issues Confronting Early-Stage Companies
Presented by Carroll D. Hurst, CPA, Partner

I. Stages In Venture Capital Investing

A. Seed or Concept Stage Capital

1. Purpose to begin to build some management, develop a business plan; perform market studies, determine commercial feasibility of product or service, fund initial research and development and some operating expenses; normally company is pre-revenue
2. Possible Funding Sources
 - a. Sweat equity
 - b. Personal savings (taxable accounts or possibly IRA funds)
 - c. Personal loans (margin accounts, home equity loans, credit cards)
 - d. Friends and family members' loans and/or equity

B. First Stage Capital

1. Company is normally a going concern with products or services being provided, so no longer pre-revenue. Some management is in place, the business plan is being refined, and the company has begun to brand itself
2. Possible Funding Sources
 - a. Accelerators or incubators (discussed in more detail later)
 - b. Venture capital funds (Series A investments)
 - c. Family offices
 - d. Government grants
 - e. Equity crowdfunding (discussed in more detail later)
 - f. Non-bank loans (small asset-based loans or receivable factoring)

- g. Leasing companies
- h. Strategic partnerships
- i. Venture debt (discussed in more detail below)

C. Second Stage Capital

1. Company is achieving growth in both its balance sheet and its revenues, and may be at or above break-even operations. A seasoned management team is in place, and attention has turned to expanding operations and sales geographically
2. Possible Funding Sources
 - a. Venture capital funds (Series B investments)
 - b. Some private equity funds, including generally those with a technology or healthcare focus, and often those with operating partners who can assist the company's management team in strategic planning, marketing and branding
 - c. Strategic partnerships
 - d. Commercial loans from traditional banks (generally asset-based financing and working capital lines of credit)
 - e. Leasing companies

D. Third or Fourth Stage Capital

1. Company is operating profitably, achieving scale in its operations, beginning to expand its product or service lines, continuing to expand geographically and build its brand
2. Possible Funding Sources
 - a. Private equity funds
 - (1) Recapitalization (minority or control investment)
 - (2) Growth capital
 - (3) Platform investment to build out through organic and acquisitive growth

- b. Senior debt financing from commercial banks
 - (1) Recapitalization (dividend)
 - (2) Growth capital
- c. Subordinated debt
- d. Unitranche or Term A and Term B senior secured debt
- e. High yield debt, generally issued to business development companies (BDCs) and hedge funds

II. Identifying Equity and Debt Financing Sources

- A. Attorneys and CPAs who specialize in representing early stage growth companies
 - 1. Location can be important (west coast vs. east coast)
- B. Investment bankers, typically with significant experience in the company's industry as well as knowledge of venture capital markets
- C. Local and regional venture capital investors and accelerators

III. Equity Debt or Convertible Debt Timing and Impact

- A. Consideration of pre-money valuations and cash burn rates on amounts of equity to be raised
 - 1. Equity can be subscribed and fully funded at closing of the subscription
 - 2. Equity can be subscribed but contributed in tranches, subject to the company meeting certain milestones, with "rolling closings" subject to those milestones being reached
 - a. Investor locks in the pre-money valuation at subscription, but a portion of the subscription could be forfeited if the milestones are not reached and the funding does not occur

3. Convertible debt (to be discussed in more detail later)
 - a. Generally issued when founder is unwilling to accept the level of dilution that would be required based on the owner's view of valuation versus an investor's view of valuation
 - (1) Coupons generally range from 6% to 8%
 - (2) Terms are generally 18-24 months with acceleration of the conversion option in the event of a follow-on equity raise
 - (3) Conversion ratios are normally 70% to 85% of fair market value as of the conversion date, with 80% to 85% being most common
 - (4) Some instruments have valuation caps on the fair market value of the company as of the conversion date
4. Venture Debt
 - a. Generally issued in support of institutional venture capital funded companies
 - (1) Generally no financial covenants
 - (2) Generally three year terms
 - (3) Generally supported by VC Series A funding
 - (4) No equity dilution other than warrants in some cases
 - (5) Can be subordinated to senior debt first lien UCC filings
5. Other Subordinated Debt
 - a. Generally issued in lieu of equity by companies that have sufficient cash flow to fund an interest coupon periodically and are willing to issue high interest rate debt in lieu of equity
 - (1) Interest coupon generally ranges from 11% to 13% and is paid periodically, often quarterly
 - (2) Terms of five years and subject to AHYDO rules
 - (3) Generally include some type of return enhancement such as paid-in-kind (PIK) interest and/or warrants

IV. Venture Capital Deal Documents and Terms (Source: NVCA)

A. Term Sheet (Sample Agreement Attached)

1. Non-binding summary of terms of a transaction, with the exception of certain binding terms such as confidentiality, exclusivity period, and costs

2. To improve flexibility in negotiations, ideally the company would have solicited funds from multiple sources and would have several term sheets from which to choose
3. Valuation and dilution considerations
 - a. Impact of unissued options and warrants on fully diluted number of shares outstanding after the issuance of new shares
4. Dividend Considerations on preferred stock issuances
 - a. Cumulative (compounded or non-compounded if accrued and unpaid)
 - b. Non-cumulative
 - c. Preferred pari-passu with common
5. Liquidation preference
 - a. Equal to the amount paid for the stock
 - b. Equal to a multiple of the amount paid for the stock (i.e. 2x or 3x)
 - c. Participating preferred liquidation preference
 - (1) Pays liquidation preference on preferred shares and permits the payout of a portion of the remaining proceeds as if the preferred shares had been converted to common shares
 - d. Non-participating preferred liquidation preference
 - (1) Pays only preferred liquidation preference
 - e. Participating preferred liquidation preference subject to a cap (i.e. a multiple of the original investment)
6. Conversion rights of preferred stock
 - a. Voting on an "as converted" basis
7. Voting Rights and Protective Provisions
 - a. See Voting Agreement section E. below

8. Anti-Dilution Provisions

- a. Protection against "down round" where the value of the company is below the original purchase price of the preferred shares
 - (1) Full ratchet-reduction of the conversion price of the shares issued in a "down round" to the issuance price of the new shares
 - (a.) Transfers all of the dilutive impact of the new share issuance to the common shareholders
 - (2) Weighted average-converts the conversion price of the preferred shares to the weighted average per share value of the original shares and the newly issued shares
 - (3) No price-based-preferred shareholders bear risk of a "down round" pari-passu with common shareholders
- b. Carve-outs to anti-dilution provisions
 - (1) Stock issued as dividend on preferred stock
 - (2) Stock issued upon conversion of a convertible note, warrant or option
 - (3) Stock splits
 - (4) Equity compensation grants
 - (5) Warrants issued to debt holders
 - (6) Stock issued as part of an acquisition
- c. Pay to Play Provisions
 - (1) If investor does not participate in a subsequent round of capital raised, the anti-dilution provisions will not apply to shares issued in that raise

9. Redemption Rights (Put Provisions)

- a. Often can be expressed based on the passage of a certain time period, generally five years but occasionally as long as seven years
 - (1) Can also be tied to achievement of a certain valuation level, but this is undesirable because of liquidity issues

10. Registration Rights

- a. Demand registration rights permit holders to require registration after passage of a period of time such as from the date of the investment or after an IPO
- b. Piggyback registration rights enables holders to participate in the registration of shares

11. Pre-emptive Rights

- a. Permits pro-rata purchase of subsequent share issuances and does not apply to carve-outs noted above

12. Co-Sale or Drag Along Rights

- a. See Right of First Refusal and Co-Sale Agreement section F. below

13. Management Rights

- a. See Management Rights Agreement section G. below

14. Founder's Shares

- a. Depending on the reasons for a founder's departure, including compliance with terms of an employment agreement, the valuation of those shares could be affected

B. Stock Purchase or Subscription Agreement

- 1. Details of the stock subscription, including number and class of shares subscribed, payment terms, milestone affecting subscription payments, representations and warranties about the company

C. Certificate of Incorporation or Articles of Incorporation

- 1. Includes rights associated with the various classes of shares and procedure for the issuance and transfer of shares, among other issues

D. Investor or Shareholder Rights Agreement

1. Typically includes investor protections, including consent rights and rights to Board representation

E. Voting Agreement

1. Governs rights to increase the number of authorized common shares, determine Board participation, and approve certain corporate actions (often requiring super-majority approval). Normally the agreement provides for the conversion of preferred shares to common for purposes of voting, with the vote based on the "as converted" number of shares
2. Super-majority approval or the vote of a majority of Board members appointed by investors, could be required for actions such as the following:
 - a. Liquidation
 - b. Issuance of new stock with rights senior to preferred stockholders (or at parity)
 - c. Issuance of debt in excess of pre-determined amounts
 - d. Redemption of stock
 - e. Board changes
 - f. Purchase of assets in excess of pre-determined amounts
 - g. Acquisitions of the stock or assets of a company
 - h. Authorization of loan transactions with officers and directors or Board members
 - i. Material changes to the compensation of the management team
 - j. Transactions not in the ordinary course of the company's business
3. Care should be taken in negotiating voting rights affecting governance provisions, as some of these provisions could adversely affect Board-management relationships and the efficient operations of the company

F. Right of First Refusal and Co-Sale Agreement (Drag-Along Rights)

1. Requires certain stockholders to agree to a sale of the company if certain conditions are met, often if 51% of the as converted shares vote in favor of a sale, but in some cases a higher percentage such as 66.7%
2. May require Board approval
3. May require a certain percentage of common share approval in addition to the preferred shares
4. May provide for a minimum price in order to be effective
5. Applies to merger or consolidation, sale of substantially all of the assets of the company, sale of voting control
6. Consider impact of drag-along rights on joint and several liability versus several liability
 - a. Dragged along shareholders should negotiate for several liability

G. Management and Information Rights Agreement

1. Relates to ERISA fiduciary rules, which do not apply to venture capital operating companies and investments in operating companies in which the fund investor obtains management rights. As such, this agreement creates these contractual rights which permit the fund investor to meet the fiduciary exemption. The rights in these agreements generally include receipt of applicable financial data, inspection rights, and the right to discuss business issues with management

H. Indemnification Agreement

1. Generally permits indemnification of the investor and any Board members appointed to the company's Board by the investor, typically a private equity or venture capital fund. These agreements will generally address the priority of indemnification liability between the company and the fund investor

I. Legal Opinion



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 - FOR POLICYMAKERS
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Model Legal Documents

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What Are The NVCA Model Venture Capital Financing Documents?

A "template" set of model legal documents for venture capital investments put together by a group of leading venture capital attorneys. The model venture capital financing documents consist of:

- [Term Sheet](#)
- [Stock Purchase Agreement](#)
- [Certificate Of Incorporation](#)
- [Investor Rights Agreement](#)
- [Voting Agreement](#)
- [Right of First Refusal and Co-Sale Agreement](#)
- [Management Rights Letter](#)
- [Indemnification Agreement](#)
- [Model Legal Opinion](#)

In general, these documents are intended to reflect current practices and customs, and we have attempted to note where the West Coast and East Coast differ in a number of their practices. However, one of our goals in drafting these documents is also to reflect "best practices" and avoid hidden legal traps, even if doing so means straying from current custom and practice. We have attempted to avoid, or at least point out, certain problematic provisions that have become "market standard" terms. We have generally tried to indicate such issues with a footnote and explanatory language.

The model documents aim to:

- reflect and in a number of instances, guide and establish industry norms
- be fair, avoid bias toward the VC or the company/entrepreneur
- present a range of potential options, reflecting a variety of financing terms
- include explanatory commentary where necessary or helpful
- anticipate and eliminate traps for the unwary (e.g., unenforceable or unworkable provisions)
- provide a comprehensive set of internally consistent financing documents
- promote consistency among transactions
- reduce transaction costs and time

What Is The Value Of These Forms?

Annually, our industry closes several thousand financing rounds, each consuming considerable time and effort on the part of investors, management teams and attorneys. A conservative estimate is that our industry spends some \$200 million in direct legal fees annually to close private financing rounds. In an all-too-typical situation, the attorneys start with documents from a recent financing, iterate back and forth to get the documents to conform to their joint perspective on appropriate language (reflecting the specifics of the deal and general industry best practices), and all parties review numerous black-lined revisions, hoping to avoid missing important issues as the documents slowly progress to their final form. In other words, our industry on a daily basis goes through an expensive and inefficient process of "re-inventing the flat tire." By providing an industry-embraced set of model documents which can be used as a starting point in venture capital financings, it is our hope that the time and cost of financings will be greatly reduced and that all principals will be freed from the time consuming process of reviewing hundreds of pages of unfamiliar documents and instead will be able to focus on the high level issues and trade-offs of the deal at hand.

RESOURCES

[Model Legal Documents](#)

[Valuation Guidelines](#)

[Document Library](#)

[Recommended Service Providers](#)

[Resources for Entrepreneurs](#)

[Publications & Products](#)

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How Will The Documents Be Kept "refreshed" And Up-to-date?

The working group (whose membership will not remain static) will continue to touch base approximately once a year to determine whether any changes need to be made to the documents, including in light of any recent legal developments or actual experience using the documents in deals. Also, users of these documents are encouraged to send any comments and suggestions to [This e-mail address is being protected from spambots. You need JavaScript enabled to view it \(Charles River Ventures\)](#). Comments and suggestions will be taken into consideration as the documents are further revised and refined over time.

Who Will "own" These Documents?

No one will own the documents. They will be in the public domain. However, the "mother" forms are posted here on the publicly accessible portion of the NVCA web site so that users downloading them from this site can be assured that they are always using the most current and up-to-date version.

DISCLAIMER: EACH DOCUMENT IS INTENDED TO SERVE AS A STARTING POINT ONLY, AND SHOULD BE TAILORED TO MEET YOUR SPECIFIC REQUIREMENTS. THE DOCUMENTS SHOULD NOT BE CONSTRUED AS LEGAL ADVICE FOR ANY PARTICULAR FACTS OR CIRCUMSTANCES.

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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

Offering Terms

Closing Date: As soon as practicable following the Company’s acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the “**Closing**”). [provide for multiple closings if applicable]

Investors: Investor No. 1: [_____] shares ([_]%), \$[_____]

Investor No. 2: [_____] shares ([_]%), \$[_____]

[as well other investors mutually agreed upon by Investors and the Company]

Amount Raised: \$[_____], [including \$[_____] from the conversion of principal [and interest] on bridge notes].²

Price Per Share: \$[_____] per share (based on the capitalization of the Company set forth below) (the “**Original Purchase Price**”).

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 thereto.”); *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.

CHARTER³

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

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:

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

CP₂ = Series A Conversion Price in effect immediately after new issue

CP₁ = 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 CP₁
- 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

⁹ The "broadest" base would include shares reserved in the option pool.

¹⁰ Note that additional exclusions are frequently negotiated, such as issuances in connection with equipment leasing and commercial borrowing. See Subsections 4.4.1(d)(v)-(viii) of the Model Certificate of Incorporation for additional exclusions.

¹¹ The per share test ensures that the investor achieves a significant return on investment before the Company can go public. Also consider allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the investor, so that the investor does not have the power to block a public offering.

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 Preferred¹² 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

¹² Alternatively, this provision could apply on a proportionate basis (e.g., if Investor plays for ½ of pro rata share, receives ½ of anti-dilution adjustment).

¹³ If the punishment for failure to participate is losing some but not all rights of the Preferred (e.g., anything other than a forced conversion to common), the Certificate of Incorporation will need to have so-called “blank check preferred” provisions at least to the extent necessary to enable the Board to issue a “shadow” class of preferred with diminished rights in the event an investor fails to participate. As a drafting matter, it is far easier to simply have (some or all of) the preferred convert to common.

¹⁴ Redemption rights allow Investors to force the Company to redeem their shares at cost (and sometimes investors may also request a small guaranteed rate of return, in the form of a dividend). In practice, redemption rights are not often used; however, they do provide a form of exit and some possible leverage over the Company. While it is possible that the right to receive dividends on redemption could give rise to a Code Section 305 “deemed dividend” problem, many tax practitioners take the view that if the liquidation preference provisions in the Charter are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the Model Certificate of Incorporation), then there is no Section 305 issue.

¹⁵ Due to statutory restrictions, the Company may not be legally permitted to redeem in the very circumstances where investors most want it (the so-called “sideways situation”). Accordingly, and particularly in light of the Delaware Chancery Court’s ruling in *Thoughtworks* (see discussion in Model Charter), investors may seek enforcement provisions to give their redemption rights more teeth - e.g., the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company’s Board of Directors, or shall have consent rights on Company cash expenditures, until such amounts are paid in full.

¹⁶ Founders’ representations are controversial and may elicit significant resistance as they are found in a minority of venture deals. They are more likely to appear if Founders are receiving liquidity from the transaction, or if there is heightened concern over intellectual property (e.g., the Company is a spin-out from an academic institution or the Founder was formerly with another company whose business could be deemed competitive with the Company), or in international deals. Founders’ representations are even less common in subsequent rounds, where risk is viewed as

Conditions to Closing: Standard conditions to Closing, which shall include, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, and an opinion of counsel to the Company.

Counsel and Expenses: [Investor/Company] counsel to draft Closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed \$[____]) and expenses of Investor counsel[, unless the transaction is not completed because the Investors withdraw their commitment without cause].¹⁷

Company Counsel: [_____

_____]

Investor Counsel: [_____

_____]

INVESTORS' RIGHTS AGREEMENT

Registration Rights:

Registrable Securities: All shares of Common Stock issuable upon conversion of the Series A Preferred [and {any other Common Stock held by the Investors}] will be deemed "**Registrable Securities**."¹⁸

Demand Registration: Upon earliest of (i) [three-five] years after the Closing; or (ii) [six] months¹⁹ 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

significantly diminished and fairly shared by the investors, rather than being disproportionately borne by the Founders. A sample set of Founders Representations is attached as an Addendum at the end of the Model Stock Purchase Agreement.

¹⁷ The bracketed text should be deleted if this section is not designated in the introductory paragraph as one of the sections that is binding upon the Company regardless of whether the financing is consummated.

¹⁸ Note that Founders/management sometimes also seek limited registration rights.

¹⁹ The Company will want the percentage to be high enough so that a significant portion of the investor base is behind the demand. Companies will typically resist allowing a single investor to cause a registration. Experienced investors will want to ensure that less experienced investors do not have the right to cause a demand registration. In some cases, different series of Preferred Stock may request the right for that series to initiate a certain number of demand registrations. Companies will typically resist this due to the cost and diversion of management resources when multiple constituencies have this right.

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 of [20-30]% on a pro rata basis and to complete reduction on an IPO at the underwriter’s discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders’ shares are reduced.

Expenses: The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions will be borne by the Company. The Company will also pay the reasonable fees and expenses[, not to exceed \$_____,] of one special counsel to represent all the participating stockholders.

Lock-up: Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company [(including/excluding shares acquired in or following the IPO)] for a period of up to 180 days [plus up to an additional 18 days to the extent necessary to comply with applicable regulatory requirements]²⁰ following the IPO (provided all directors and officers of the Company [and [1 – 5]% stockholders] agree to the same lock-up). [Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to Investors, pro rata, based on the number of shares held.

Termination: Upon a Deemed Liquidation Event; [and/or] when all shares of an Investor are eligible to be sold without restriction under Rule 144 [and/or] the [_____] anniversary of the IPO.

No future registration rights may be granted without consent of the holders of a [majority] of the Registrable Securities unless subordinate to the Investor’s rights.

²⁰ See commentary in footnotes 23 and 24 of the Model Investors’ Rights Agreement regarding possible extensions of lock-up period.

Management and Information Rights:

A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.²¹

Any [Major] Investor [(who is not a competitor)] will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such Major Investor (i) annual, quarterly, [and monthly] financial statements, and other information as determined by the Board; (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year[; and (iii) promptly following the end of each quarter an up-to-date capitalization table. A "Major Investor" means any Investor who purchases at least \$[_____] of Series A Preferred.

Right to Participate Pro Rata in Future Rounds:

All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet. In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

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;

²¹ See commentary in introduction to Model Managements Rights Letter, explaining purpose of such letter.

(vi) enter into or be a party to any transaction with any director, officer or employee of the Company or any “associate” (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such person [except transactions resulting in payments to or by the Company in an amount less than \$[60,000] per year], [or transactions made in the ordinary course of business and pursuant to reasonable requirements of the Company’s business and upon fair and reasonable terms that are approved by a majority of the Board of Directors];²² (vii) hire, fire, or change the compensation of the executive officers, including approving any option grants; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; (ix) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (x) enter into any corporate strategic relationship involving the payment contribution or assignment by the Company or to the Company of assets greater than [\$100,000.00].

*Non-Competition and Non-Solicitation Agreements:*²³

Each Founder and key employee will enter into a [one] year non-competition and non-solicitation agreement in a form reasonably acceptable to the Investors.

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

²² Note that Section 402 of the Sarbanes-Oxley Act of 2003 would require repayment of any loans in full prior to the Company filing a registration statement for an IPO.

²³ Note that non-compete restrictions (other than in connection with the sale of a business) are prohibited in California, and may not be enforceable in other jurisdictions, as well. In addition, some investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a Non-Compete/Non-Solicit (and indeed the agreement may arguably be invalid absent such additional consideration - although having an employee sign a non-compete contemporaneous with hiring constitutes adequate consideration in jurisdictions where non-competes are generally enforceable). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Non-competes typically have a one year duration, although state law may permit up to two years. Note also that some states may require that a *new* Non-Compete be signed where there is a material change in the employee’s duties/salary/title.

corporation, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume the Company's obligations with respect to indemnification of Directors.

Employee Stock Options:

All employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months].

[Immediately prior to the Series A Preferred Stock investment, [_____] shares will be added to the option pool creating an unallocated option pool of [_____] shares.]

Key Person Insurance:

Company to acquire life insurance on Founders [*name each Founder*] in an amount satisfactory to the Board. Proceeds payable to the Company.

RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT

*Right of First Refusal/
Right of Co-Sale
(Take-Me-Along):*

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

VOTING AGREEMENT

Board of Directors:

At the initial Closing, the Board shall consist of [_____] members comprised of (i) [*name*] as [the representative designated by [____]], as the lead Investor, (ii) [*name*] as the representative designated by the remaining Investors, (iii) [*name*] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [____] person(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].

[Drag Along]:

Holders of Preferred Stock and the Founders [and all future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in

²⁴ Certain exceptions are typically negotiated, e.g., estate planning or *de minimis* transfers. Investors may also seek ROFR rights with respect to transfers by investors, in order to be able to have some control over the composition of the investor group.

favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by [the Board of Directors] [and the holders of ___% of the outstanding shares of Preferred Stock, on an as-converted basis (the “**Electing Holders**”)], so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder's pro rata portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Certificate of Incorporation.]²⁵

[Sale Rights:

Upon written notice to the Company from the Electing Holders, the Company shall initiate a process intended to result in a sale of the Company.]²⁶

OTHER MATTERS

Founders' Stock:

All Founders to own stock outright subject to Company right to buyback at cost. Buyback right for [__]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [__] months.

[Existing Preferred Stock:²⁷

The terms set forth above for the Series [__] Preferred Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing Preferred Stock to this term sheet will be made at the Closing.]

No Shop/Confidentiality:

The Company agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, for a period of [_____] weeks from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this no-shop obligation and, prior to [_____] , closes any of the above-referenced transactions [without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction], then the Company shall pay to

²⁵ See Subsection 3.3 of the Model Voting Agreement for a more detailed list of conditions that must be satisfied in order for the drag-along to be invoked.

²⁶ See Addendum to Model Voting Agreement

²⁷ Necessary only if this is a later round of financing, and not the initial Series A round.

the Investors \$[_____] upon the closing of any such transaction as liquidated damages.]²⁸ The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [_____] , as lead Investor, without the written consent of the Investors.

Expiration:

This Term Sheet expires on [_____, 20__] if not accepted by the Company by that date.

EXECUTED THIS [__] DAY OF [_____] ,20[____].

[SIGNATURE BLOCKS]

²⁸ It is unusual to provide for such "break-up" fees in connection with a venture capital financing, but might be something to consider where there is a substantial possibility the Company may be sold prior to consummation of the financing (e.g., a later stage deal).

EXHIBIT A

Pre and Post-Financing Capitalization

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

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