

Form:

Term Sheet for Equity Investment and Strategic Alliance

Description:

A sample term sheet for an equity investment coupled with a strategic partnership.

TERM SHEET FOR POTENTIAL
EQUITY INVESTMENT
IN [NAME OF COMPANY]^{1/}
AND STRATEGIC ALLIANCE

This term sheet summarizes the principal terms with respect to a potential private placement of equity securities of _____ (the "Company") by _____ ("Investor") and related strategic alliance. This term sheet is intended solely as a basis for further discussion and is not intended to be and does not constitute a legally binding obligation. No legally binding obligations will be created, implied, or inferred until a document in final form entitled "Series Stock Purchase Agreement," is executed and delivered by all parties. Without limiting the generality of the foregoing, it is the parties intent that, until that event, no agreement shall exist among them and there shall be no obligations whatsoever based on such things as parol evidence, extended negotiations, "handshakes," oral understandings, or courses of conduct (including reliance and changes of position).^{2/}

The Company and the Investor are discussing a private placement of shares of Preferred Stock on the following terms:

Amount of Investment: \$ _____^{3/}

Valuation of the Company: \$ _____ Pre-Money^{4/} on a fully diluted basis
\$ _____ Post-Money on a fully diluted basis

Type of Security: Shares of the Company's Series _ Preferred Stock ("Preferred"), convertible into shares of the Company's Common Stock ("Common").

Price Per Share: \$ _____ ("Original Purchase Price").

Capitalization of the Company: The current capitalization of the Company is set forth in Exhibit 1, and the capitalization of the Company after this proposed financing is set forth in Exhibit 2.^{5/}

^{1/} Other sample term sheets can be found at www.AllBusiness.com.

^{2/} The concern addressed by the last two sentences is whether an agreement in principle or term sheet could be construed to be a contract binding on the investor group. From the investor's perspective, they will not want to be bound in any way until all conditions precedent have been met, such as completion of due diligence and execution of a definitive purchase agreement. The language in the first paragraph of the text would have to be modified if the investors are expecting a "lock-up" or option to invest in the Company, on the terms set forth in the Term Sheet.

^{3/} Sometimes this amount is structured as a range, e.g., "A minimum of \$3,000,000 and a maximum of \$6,000,000." Also, the investment is sometimes structured as a staged pay-in, with subsequent installments to be invested if the Company has met certain milestones.

^{4/} This is the agreed upon valuation of the Company prior to the investor contributing money to the Company. Valuation per share will often take into account outstanding stock options and warrants.

^{5/} Exhibit 1 should show outstanding warrants, stock options, employee stock and vesting provisions, employee reserved stock and options, and outstanding Common, Preferred, and convertible securities. It may be useful for Exhibit 2 to show the capitalization of the Company taking into account the effect of anti-dilution provisions of any prior preferred stock issuances.

Rights, Preferences, Privileges
and Restrictions of Preferred
Stock:

(1) Dividend Provisions: [Starting on January 1, 19__,]
[T]he holders of the Preferred will be entitled to receive
dividends [at the rate of _% of the Original Purchase Price]
whenever funds are legally available and when and as
declared by the Board. No dividend shall be paid on the
Common at a rate greater than the rate at which dividends are
paid on Preferred (based on the number of shares of
Common into which the Preferred is convertible on the date
the dividend is declared). Dividends on Preferred will be in
preference to dividends paid on the Common. Dividends on
the Preferred will be noncumulative.^{6/}

(2) Liquidation Preference: In the event of any liquidation,
dissolution or winding up of the Company, the holders of
Preferred will be entitled to receive in preference to the
holders of Common^{7/} an amount ("Liquidation Preference")
equal to the Original Purchase Price plus any dividends
declared on the Preferred but not paid [and then to share with
the holders of the Common in the remaining assets on an
as-if-converted basis].^{8/} At the option of the holders of
Preferred, the effectuation by the Company or third party
acquirors of a transaction or series of transactions in which
more than [50%] [80%] of the voting power of the Company
is disposed of to a single person or group of affiliated
persons or the consolidation or merger of the Company with
or into any other corporation or corporations or the sale of all
or substantially all of its assets shall be deemed to be a
liquidation, dissolution or winding up for purposes of the
liquidation preference.

(3) Conversion: A holder of Preferred will have the right to
convert Preferred, at the option of the holder, at any time,

^{6/} Because most start-up and emerging companies will not be typically in a position to pay dividends to the holders of the Preferred Stock, many dividend provisions for those companies are drafted as to not mandate or cumulate dividends. However, in some financings, the investor may require that dividends accrue and cumulate whether or not declared by the Board. Where dividends cumulate, companies will want all previously accrued but unpaid dividends to be waived upon the automatic conversion of the Preferred Stock; investors will want the unpaid dividends to be paid or to be converted into common stock. If dividends are required, the Company will want the dividends not to commence immediately and to have the option to pay such dividends in cash or stock.

^{7/} If the Company has other series or classes of Preferred Stock, this provision will need to address the liquidation preferences of those past issuances vis-a-vis the new Preferred issuance. For example, is a Series B round to be equal or superior to the liquidation preference of a Series A round?

^{8/} The bracketed language provides for a "participating preferred," where on liquidation the Preferred first receives an amount equal to the original purchase price and unpaid dividends, plus an amount pro-rata with the Common as if the Preferred were converted. The Company will typically strongly resist this participating feature or attempt to mitigate its effect (e.g., the participating feature will not apply if the investors have made at least a 300% return on their investment). This participating provision results in the payment of the Liquidation Preference on each share of Preferred from the proceeds of a merger or sale of the Company. After such payment, all holders of Preferred and Common typically share the balance of the proceeds on an "as converted" basis. Entrepreneurs who hold Common are often disappointed when they realize that the payment of the Liquidation Preference results in sharply lower per share prices for their Common. A participating preferred provision can also result in situations where investors may favor a sale of the Company that founders would not want.

into shares of Common. The total number of shares of Common into which Preferred may be converted initially will be determined by dividing the Original Purchase Price by the conversion price. The initial conversion price will be the Original Purchase Price. The conversion price will be the subject of adjustment to reflect stock dividends, stock splits and similar events and as provided in paragraph (5) below.

(4) Automatic Conversion:^{9/} The Preferred will be automatically converted into Common, at the then applicable conversion price, upon the closing of a sale of the Company's shares of Common Stock pursuant to a firm commitment underwritten public offering by the Company at a public offering price per share (prior to underwriter commissions and discounts) that is not less than \$_____ ^{10/} in an offering greater than \$[_____].^{11/}

(5) Antidilution Provisions: The conversion price of the Preferred will be subject to adjustment (i) for stock dividends, stock splits, or similar events, and (ii) on a weighted average basis to prevent dilution in the event that the Company issues additional shares at a purchase price less^{12/} than the applicable conversion price.^{13/} No adjustment to the conversion price will occur for any issuance of additional shares at a purchase price in excess of the current conversion price. Conversion prices will not be adjusted because of (a) conversion of Preferred Stock, or (b) the issuance and sale of, or the grant of options to purchase, _____ ^{14/} shares of Common pursuant to the Company's employee stock purchase or option plans (the "Reserved

^{9/} The purpose of this automatic conversion provision is to clean up and simplify the Company's capitalization structure at the initial public offering stage. The underwriters in an IPO will want the capitalization structure cleaned up as much as possible.

^{10/} This number is typically 3 to 7 times the original purchase price per share of the Preferred, depending on the stage of the Company's progress at the time of this financing. The investors do not want to be forced to convert to Common Stock unless they have received a sufficient return on their investment.

^{11/} This number can range from \$15 million to \$50 million. Automatic conversion of the Preferred is also sometimes required (i) when less than 25% of the Preferred shares issued in this financing remain outstanding or (ii) upon the affirmative vote of more than 50% of the outstanding Preferred.

^{12/} An alternate provision, the so-called "ratchet provision," which is quite onerous from the Company's standpoint, provides that upon a dilutive financing, the conversion price of the diluted shares is adjusted downward to the issuance price of the dilutive financing. An additional provision, the so-called "pay to play provision," which can be burdensome from the investors' standpoint, provides that the investors must participate pro rata in the dilutive financing (or perhaps even in all future financings) in order to retain antidilution protection for their shares. Lead investors sometimes require a pay to play provision to prevent "free-riding" by minor investors. The "pay to play" provision could also provide that any investor that does not participate pro rata in future financings (or dilutive future financings) would be converted to Common Stock.

^{13/} Occasionally, the Company is able to request and obtain a provision that requires the antidilution provisions to take into account future Company issuances of stock at a price greater than the conversion price, to ameliorate the effect of stock issued at lower than the conversion price. However, the investors will usually not allow the conversion price to ever be higher than the initial conversion price due to such a provision.

^{14/} This number is typically 10%-20% of the Company's capital stock.

Employee Shares”).

(6) Voting Rights: Except with respect to election of Directors, a holder of Preferred will have the right to that number of votes equal to the number of shares of Common issuable upon conversion of its Preferred at the time the shares are voted. Election of Directors will be as described under “Board Representation” below.

(7) Protective Provisions: [So long as there are at least ___ shares of Preferred outstanding,]^{15/} consent of the holders of at least a majority of the outstanding Preferred will be required for any action which would: (i) amend or repeal any provision of, or add any provision to, the Company’s [Articles] [Certificate]^{16/} or Bylaws to change the rights of the Preferred, or increase or decrease the number of authorized shares of the Preferred; (ii) create any new series or class or shares having a preference or priority as to dividends or assets superior to or on a parity with that of the Preferred; (iii) create any bonds, notes or other obligations convertible into, exchangeable for or having option rights to purchase shares of stock with any preference or priority as to dividends or assets superior to or on a parity with that of the Preferred; (iv) reclassify any class or series of Common into shares with a preference or priority as to dividends or assets superior to or on a parity with that of the Preferred; (v) apply any of its assets to the redemption or acquisition of any shares of Common, except from employees, advisors, officers, directors, consultants and serviceproviders of the Company on terms approved by the Board; or (vi) agree to a merger, sale or consolidation of the Company with another entity or the effectuation of any transaction or series of related transactions in which more than [50%] [80%] of the voting power of the Company is disposed.

Redemption:^{17/}

The Company shall redeem the Preferred in [three] equal annual installments commencing [six] years from the date of purchase by paying in cash an amount equal to the Original Purchase Price plus any declared but unpaid dividends [plus % for each year the Preferred Stock is outstanding]. To the

^{15/} The Company may request the bracketed language, so that the protective provisions would no longer apply if the number of outstanding shares of the Preferred were reduced to a designated percentage (e.g., 25%). Note, however, that if California law were to govern, the remaining Preferred holders would have a class vote in certain events. See Cal. Corp. Code Section 903.

^{16/} The term "Articles" is used for California corporations and "Certificate" for Delaware corporations.

^{17/} The Company will typically resist a redemption feature, on the theory that the expected liquidity will be achieved when the Company goes public or is acquired. The investor may insist on the redemption feature to force the Company to cash it out at some point (assuming funds are available), if the other liquidity options have not materialized. Redemption features may have important tax consequences.

extent that the Company may not at any such date legally redeem such Preferred, such redemption will take place as soon as legally permitted.^{18/}

Information and information
Registration Rights:^{19/}

(1) Registration Rights Agreement: The and registration rights provisions between the Company and any past purchasers of the Company's stock shall be merged with the registration rights of the investors in this transaction to be set forth in an Information and Registration Rights Agreement (the "Rights Agreement").

(2) Information Rights: So long as an investor holds Preferred (or Common issued upon conversion of Preferred), the Company will deliver to such investor annual audited and quarterly unaudited financial statements. So long as the investor holds at least _%^{20/} of the Preferred (or Common issued upon conversion of the Preferred), and the Company has not gone public, the Company will timely furnish such investor with budgets and monthly financial statements.

(3) Demand Rights on Forms other than Form S-3: If, at any time after the earlier of the Company's initial public offering and the date [three] years from the purchase of the Preferred (but not within 180 days of the effective date of a registration), investors holding at least _%^{21/} of the Preferred (or Common issued upon conversion of the Preferred) request that the Company file a Registration Statement for at least _%^{22/} of the Common issued or issuable upon conversion of the Preferred (or any lesser percentage if the aggregate offering price to the public would exceed \$ _____),^{23/} the Company will use its best efforts to cause such shares to be registered. The Company will not be obligated to effect more than two registrations (other than on Form S-3) under these demand registration right

^{18/} Investors may require that if a redemption is not made on schedule, the conversion price of the shares not so redeemed shall be reduced by some percentage. In some cases, the unredeemed shares' conversion price continues to be adjusted downward until the shares are redeemed.

^{19/} A short form provision that would replace sections (1) through (9) under this Information and Registration Rights provision is as follows:

"The investors shall have demand, piggyback, and S-3 registration rights and related rights, and information rights, in the manner customary for transactions of this nature, all as to be detailed in the definitive documents."

^{20/} This number is typically 5% to 10%.

^{21/} This number is typically 25% to 50%.

^{22/} This number is typically 25% to 50%.

^{23/} This number can range from \$1 million to \$5 million.

provisions.^{24/}

(4) Registrations on Form S-3: Holders of at least _% of the Preferred (or Common Stock issuable upon conversion of the Preferred) will have the right to require the Company to file an unlimited number of Registration Statements of its Common Stock on Form S-3 (or any equivalent successor form) if the anticipated aggregate public offering price to the public would exceed \$_____.^{25/}

(5) Piggy-Back Registration: The investors will be entitled to “piggy-back” registration rights on registrations of the Company or on any demand registrations, subject to the right of the Company and its underwriters, in view of market conditions, to reduce or eliminate the number of shares of the investors proposed to be registered.^{26/}

(6) Registration Expenses: All registration expenses (exclusive of underwriting discounts and commissions) and special counsel fees of a selling shareholder shall be borne by the Company.

(7) Transfer of Registration Rights: The registration rights may be transferred to a transferee (other than a competitor of the Company) who acquires at least [25%] of the shares held by a holder of Preferred (or Common issued upon conversion of Preferred).

(8) Future Purchasers of Company Securities:^{27/} Subsequent purchasers of the Company’s securities may be granted [comparable information and registration rights without the consent of the holders of the Preferred] [information and registration rights upon consent of the holders of at least [51%] of the holders of Preferred (or Common issued upon conversion of Preferred)].

(9) Other Registration Provisions: Other provisions will be contained in the Stock Purchase Agreement with respect to registration rights as are customary, including

^{24/} The Company may request that it will not be obligated under the demand registration rights provisions if SEC Rule 144, 144A, or a comparable rule is available to the investors for the proposed sale.

^{25/} Typically \$500,000 to \$1,000,000. It is negotiable as to who bears the expense of such S-3 registrations; at least after some minimum number.

^{26/} The Company may request that the piggy-back rights not be exercisable if the investors are able to use the benefits of SEC Rule 144, 144A, or a comparable rule.

^{27/} The Company has to address the issue of what registration rights can be given to future investors, and what consents from this round of investors will be necessary.

cross-indemnification, the Company's ability to delay the filing of the demand registration for a period of not more than 120 days, the agreement by purchasers of the Preferred if requested by the underwriter in a public offering not to sell any Company securities they hold for a period of up to 180 days following the effective date of the Registration Statement of such offering, underwriting arrangements and the like. The registration rights will only apply to Common issued upon conversion of Preferred and the Company shall have no obligation to register an offering of Preferred.

Board Representation:

The authorized number of directors of the Company will be not less than ___ nor more than ___, to be initially fixed at ___. So long as [25%] or more of the Preferred issued in this financing remain outstanding, the Preferred (voting as a class) will elect ___ directors and the Common (voting as a class) will elect ___ directors. If at any time, less than [25%] of the Preferred remains outstanding, all of the directors will be elected by the Preferred and Common voting together as one class, and the Preferred will be entitled to vote as if all of the Preferred were converted to Common.^{28/}

Use of Proceeds:

The proceeds from the sale of the Preferred will be used for working capital.^{29/}

Employment Relationships:

The Company has or will have prior to the closing employment agreements with the following persons: _____. The Company will hire persons to the following positions: _____.^{30/}

Market Standoff Agreements:^{31/}

The Company, prior to closing, will cause all present holders of the Company's Common and all present holders of options to purchase the Company's Common to execute a Market Standoff Agreement with the Company pursuant to which such holders will agree, if so requested by the Company or any underwriter's representative in connection with the first public offering of the Company's Common, not to sell or otherwise transfer any securities of the Company during a period of up to 180 days following the effective date of the registration statement. The Company will require all

^{28/} This provision can be highly negotiated and subject to many alternatives.

^{29/} If the proceeds are to be used for a specific purpose, this provision will need to be amended accordingly.

^{30/} In early stage companies, strategic investors may insist that new executive officers, acceptable to the investor, be employed.

^{31/} This would not be typically applicable for later rounds of financings, as early stage investors will have likely insisted on such agreements. Often, the Market Standoff Agreement is folded into the Stock Restriction and Vesting Agreement.

future purchasers of stock prior to the Company's initial public offering to execute such a Market Standoff Agreement.

Reserved Employee Shares:	The Company may reserve up to _____ ^{32/} shares of Common (the "Reserved Employee Shares") inclusive of shares presently reserved for issuance upon the exercise of outstanding options for issuance to employees and consultants. The Reserved Employee Shares will be issued from time to time under such arrangements, contracts or plans as are approved by the Board of Directors. Issuance of shares or options to employees in excess of the Reserved Employee Shares will be subject to the investors' right of first refusal described below. Holders of Reserved Employee Shares will be required to execute Stock Restriction and Vesting Agreements as described above.
Right of First Refusal:	In the event that the Company offers equity securities (other than Reserved Employee Shares, or upon conversion of outstanding Preferred, or upon exercise of outstanding options or warrants, or in connection with an acquisition or in a public offering), each investor [who holds at least ___% of the Preferred Stock issued in this private placement] shall have a right of first refusal to purchase the same percentage of such offering as such holder purchased of the shares of Preferred issued in this private placement. This right will terminate upon the Company's initial public offering.
Confidential Information and Inventions Assignment Information Agreement:	Each officer, director and key employee of the Company will enter into a Confidential and Inventions Assignment Agreement in a form reasonably acceptable to the Company and the investors. ^{33/}
The Stock Purchase Agreement:	The purchase of the Preferred, if consummated, will be made pursuant to a Stock Purchase Agreement (with exhibits) drafted by counsel to the Investor and acceptable to the Company and the Investor. The Stock Purchase Agreement will contain, among other things, representations and warranties of the Company, ^{34/} covenants of the Company, ^{35/} and conditions to the obligations of the Investor.

^{32/} This number is typically 10%-20% of the Company's capital stock.

^{33/} Sample forms of a Confidential Information and Inventions Assignment Agreement can be found at www.AllBusiness.com.

^{34/} The investor may also want representations and warranties from the founders, such as with respect to technology and inventions developed by the founders. Typical representations and warranties of the Company will include the following: organization and standing; capitalization, corporate power and authorization; subsidiaries; validity of securities; governmental consents; compliance with other instruments and laws; litigation; proprietary information agreements with employees; intellectual property; financial statements; absence of certain changes; material contracts and commitments; registration rights; title to property and assets; outstanding indebtedness and liabilities; shareholder agreements; employee compensation and

The Strategic Alliance Agreement:

The parties will enter into [a series of strategic alliance agreements as follows: _____] [a license agreement containing the following key points: (1) a license to the Investor for use of the Company's technology for the following purposes: _____; (2) a royalty fee payable as follows: _____; (3) exclusivity of the license as follows: _____; (4) term of the license with renewal rights as follows: _____]. [A distribution and marketing agreement containing the following key points: _____].

Conditions of Closing:

The closing for the purchase of the purchase of the Preferred will be conditioned upon:

- (1) Completion of due diligence to the satisfaction of the investors in their sole discretion.
- (2) Execution by the Company of a Stock Purchase Agreement and related agreements satisfactory to the investors in their sole discretion.
- (3) Compliance by the Company with applicable securities laws.
- (4) Opinion of counsel to the Company rendered to the investors in form and substance satisfactory to the investors.
- [(5) Key man life insurance having been obtained for the benefit of the Company on for \$_____ [, provided that the Company can obtain such insurance at normally prevailing rates for persons in good health].]
- (6) Execution of strategic alliance agreement.
- [(7) Other material conditions.]
- (8) Such other conditions as are customary for transactions of this type.

Expenses:

The Company will pay the reasonable legal fees and expenses incurred by a single counsel to the Investor.^{36/}

pension plans; labor union activities; employee relations; tax returns and audits; disclosure and business plan; insurance; certain transactions; brokers or finders; Foreign Corrupt Practices Act; environmental regulations; returns and complaints; Section 83(b) elections; outstanding securities; and use of proceeds.

^{35/} Covenants will often include requirements by the Company to provide investors (or investors who hold a designated minimum number of shares) with monthly, quarterly, and annual financial and other information.

^{36/} Alternatively, the provision could state that each side pays its own expenses. If the Company agrees to pay the other side's legal fees and expenses, the Company will often request that: (1) a cap be placed on the amount of reimbursable fees paid for by the Company, and (2) payment of the legal fees and expenses be expressly conditioned on a closing of the financing. The

Finders: The Company and the Investor each will indemnify the other for any finder's fees for which that party is responsible.

Closing: The closing of the transaction, if all conditions are met, is expected to occur on or before _____, [Date]_____.

Counsel to the Investors: _____
Phone: (____)_____
Fax: (____)_____
Attn: _____

Counsel to the Company: _____
Phone: (____)_____
Fax: (____)_____
Attn: _____

Distribution List: The parties list for distribution of documents is set forth as Exhibit 3.

Investor may request reimbursement for its due diligence expenses incurred, such as for outside consultant fees paid. This provision might also provide that payment of the Investor's legal and other expenses will be made at the closing.

Exhibit 1

[Current Capitalization
of the Company]

Exhibit 2

[Capitalization of the Company
after the Proposed Financing]

Exhibit 3

[Distribution List for Documents]