

WHAT EVERY ENGINEER
SHOULD KNOW ABOUT
**STARTING A
HIGH-TECH
BUSINESS
VENTURE**

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And Finally, The “Yes and Here’s a Term Sheet”

The finish line is in sight: a term sheet. As the initial meetings and business diligence processes come to a conclusion, the final step in the solicitation process will culminate with a presentation to the firm partners (usually instigated by your champion). After this presentation, the partners will discuss the business and make a decision to invest.

Find out when the partners of the VC firm have their weekly meeting (traditionally, Silicon Valley firms have scheduled these meetings on Monday mornings). It may be a good idea to follow up with your champion the following day, after the fund has their all-partner meeting. Use this information to see where the partnership stands on your potential investment.

Then begins the process of turning that yes over the phone or in a meeting, into a financing contract and cash in the bank. The first step will be receipt of a term sheet from the investor, nearly always drafted by the lawyers for the venture capital firm.

Once you’ve received the term sheet, the work of the company is far from complete. The company must now drive the process to completion to secure the funding. One mistake many entrepreneurs make is failing to realize that, once a term sheet has been received, the company must manage the process to close the investment, including final negotiation of the term sheet and working with legal counsel to finalize the investment contracts. The company should work closely with the venture capital firm and partner, but don’t assume that the VC will oversee the deal for the company. Traditionally, the company should use its advisors and counsel to set a timeline and manage completion of the transaction.

Understanding the VC Term Sheet

After a handshake and a few pats on the back, a partner at the venture capital firm will inform you to “Look for a term sheet from us very soon.” This represents excellent news for the company and the fundraising team, but it doesn’t mean the work of the company is done just yet. Now comes the final push to seal the deal and get the cash in the bank, which involves determining whether the investment meets the company’s needs, doing your diligence on the investor, and getting a better understanding of the terms of the deal.

To see a sample Series A term sheet, go to the information at the end of this chapter or visit the book’s website at <http://www.myhightechstartup.com>.

WHAT IS A TERM SHEET?

A “term sheet” or “memorandum of understanding” is basically an outline and a blueprint for the financing deal. It saves time and confusion later on by allowing the deal to be structured around the terms agreed on in the term sheet. It also serves as the easiest way for the principals to focus on and agree on the deal points.

After the term sheet is negotiated, then the documents of the deal will be drafted to incorporate the points in the term sheet. These deal points may seem somewhat trivial (who cares about antidilution or liquidation preferences, or even knows what they mean for that matter?) The truth is, these seemingly trivial deal points influence the company over the long run and will need a thorough review before agreeing to the deal.

If you are fortunate enough, the company may even receive several term sheets over the coming days and weeks, and, in that case, you will need to evaluate the investor and the deals they are proposing.

The Process of Term Sheet Preparation

The term sheet will usually be drafted by the VC and primary negotiations will be between the company and the investors. However, the startup may be responsible for drafting the term sheet in seed round or Series A financing round if there is no “professional” (VC or corporate) or “lead” investor in the round. It is advisable to have your attorney review the term sheet before transmission to the investors to ensure that the terms are accurately reflective of the current marketplace.

WHY PREFERRED STOCK?

Venture financings typically involve the sale of convertible preferred stock. The special rights of the preferred stock support a two-tiered capital structure, with higher-priced preferred stock being sold to investors and lower-priced common stock being issued to employees. A typical price differential between preferred and common stock for an early stage company would be between approximately 2:1 and 10:1, respectively (this price or value differential is just a rule of thumb and is due to the addition rights provided to the preferred stock, including liquidation preferences, voting rights, participation rights, and veto powers). The convertibility of the preferred stock permits the investors to become common shareholders if it is in their economic interests to do so.

The chief disadvantage of issuing preferred stock is that, at least under California corporation law, preferred shareholders are entitled to a separate class vote on certain matters. For example, the preferred shareholders of a California corporation are entitled to veto a merger involving the company. Even if the company is incorporated in a state such as Delaware, where class voting does not apply to a merger, the investors will typically insist that a separate class vote on mergers and other matters be included in the financing documents.

The proposed transaction will generally begin with a term sheet drafted by one side (usually the investor). Once you receive the term sheet from the investor or his counsel, it becomes the company’s turn to examine and revise the term sheet. This begins the process wherein the term sheet is revised and rerevised to reflect the ongoing negotiations of the parties. In other situations, the term sheet may reflect terms that have already been agreed on orally. Once a final term sheet has been formulated, the parties are ready to begin drafting documents that will reflect those terms, as well as the finer points to be worked out in the drafting stage of the transaction.

In negotiating the terms of an initial round of venture financing, the company and the investors will generally first try to agree on several key terms (which could be potential deal killers). These initial discussions will likely center on the premoney valuation of the company and the dollar value of the investment.

The premoney valuation of the company is usually based on the business plan, prospects, and any technology owned or developed by the company before the investment. (Valuation will be discussed in further detail below.) The size of the investment will then determine the percentage of the company being acquired by the investors. The per share price of the preferred stock issued in the financing is a function of the premoney valuation and the number of shares and options outstanding before the financing. Sophisticated investors will treat the shares reserved for future stock and option grants, if any, as being fully issued when calculating the per share price.

IS THE TERM SHEET BINDING?

For the most part, no. Usually a VC term sheet provides that it is nonbinding; that is, even after the terms have been agreed on for the term sheet, neither party is obliged to consummate the transaction until it has executed a purchase agreement.

However, as you can see below, this model term sheet does provide that a few items will be binding. These binding items are (1) the no-shop/confidentiality provisions that don't permit the company to shop the deal or communicate about the deal once the term sheet is signed, and (2) the legal fees of the investor will be paid by the company even if the deal doesn't happen.

"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 [State of Delaware]."

Source: Preamble to the "Model Term Sheet for a Series A Financing," National Venture Capital Association

Negotiating and revising a term sheet usually involves a number of tactical considerations by the company and its attorneys. One approach to the term sheet negotiation is to modify the term sheet to include terms that heavily favor the company. This may allow the company to "give" on certain issues down the road. Another approach is to offer revisions that would tend to be the "middle ground" to avoid lengthy back-and-forth negotiations. The strategy to use here will depend on the leverage of the company, the relationship of the parties, and the level of sophistication for each of the parties to the transaction. The company will also need to determine the level of detail it hopes to include in the term sheet. Attempting to include the bulk of the key details of the transaction in the term sheet will make the document drafting and closing process much simpler but could force discussions around issues that otherwise might not be discussed if simply included in the financing agreements.

TERM SHEET NEGOTIATION TIPS AND TECHNIQUES

Negotiating a term sheet with a venture capital firm may seem like a challenge, and there will be some challenging aspects to the negotiations. However, remember that the venture capital firm understands and expects some negotiating around the term sheet. Everyone hopes to get the deal done, so be pragmatic and consider the big picture when working to finalize the term sheet. Some key considerations of the negotiation process include the following:

- **Determine the lead investor and a single investor's counsel.** Negotiating with multiple investors and multiple lawyers can be time consuming and expensive. If you have multiple investors, ask to have a lead investor designated and shared investor's counsel.
- **Involve your attorney.** If you have hired an attorney that has done venture financing deals, your attorney likely knows what terms are reasonable and where you should focus your negotiations.
- **Model it out.** There are a lot of variables at play here and changes in some can drastically change the payouts down the road. Model out the investment over the five-year period in your projections and see the impact of changes in the valuations, liquidation preferences, etc. Look at hypothetical transactions down the road (What if we sold for \$20 million in two years or \$100 million in four years?) or see what occurs if the business goes belly up down the road. Find someone that is skilled in Excel and ask for their help to build the financing (and possible future financings) into a model.
- **Prioritize your negotiations.** The term sheet will have numerous terms that could be negotiated, but a heavily edited term sheet could kill the deal. Focus your comments on a few key items, such as company valuation, the size of the option pool used to attract future employees, the number of board members, compensation for the founders, vesting on founders stock, and liquidation preference.
- **VCs don't have "standard" deal terms.** A VC or attorney may tell you that certain deal points or provision are "standard" or "always the way we do it." However, that doesn't mean it isn't negotiable. Although it may be a preference or typical, each investment is different and few terms (if any) are never changed in the context of a deal.
- **Act professionally if you are evaluating multiple term sheets.** In the event you are considering multiple investment offers or are awaiting a term sheet from an investor who is likely to invest, be certain that you keep the potential investors informed of your timetable. Investors who feel like they are being played against one another will oftentimes balk at the deal and find another candidate for their investment.
- **Remember that you have to work with the VC after you close the financing.** Negotiating a term sheet (and closing the entire deal) can seem adversarial, but don't create a situation in which you can't work with the VC who will ultimately be serving on your board of directors. VCs expect to negotiate the deal, expect issues to arise in the process, but expect to get the deal done.

The Terms of a Term Sheet

To help you understand some of the provisions, a sample term sheet for a Series A preferred stock financing is included at the end of this chapter to help the entrepreneur see what to expect.

COMPARING YOUR TERM SHEET

Once you receive a term sheet, your attorney may be able to provide industry knowledge on the terms their clients have received in previous venture capital financings with a specific venture firm.

In addition, the website <http://TheFunded.com> provides members the ability to upload venture capital term sheets they have received previously (and either accepted or rejected) to allow other members to compare and contrast individual terms from each VC. The site is limited to members only, and applications for membership require a link to an online biography. The service is free for founders and entrepreneurs and allows users to review and rate funding sources.

In the context of a preferred stock financing, the term sheet is used to describe (1) the essential characteristics of the stock to be issued, (2) the capitalization of the company, (3) the main conditions to closing, and (4) registration rights, information rights, and any other rights and obligations that will survive the closing. Below is a list of some of the most typical terms in a financing term sheet:

- Short preamble or summary of the deal
- Type of stock being sold (usually preferred stock)
- Price per share and total funding
- Consideration (usually cash or converted bridge loans)
- Date of the deal's closing or the dates of multiple closings
- Names of the investors and the general breakdown in ownership
- Pre- and postfinancing valuation of the company
- Attributes of the stock in the deal, including (1) dividends, (2) liquidation preference, (3) redemption, (4) conversion, (5) antidilution, and (6) statutory voting rights
- Counsel fees
- Standstill and no-shop provisions

SUMMARY OF KEY TERM SHEET ISSUES

The following represents a list of the key issues that are often negotiated and the various choices and alternatives found in a VC term sheet:

Term	Choice or alternative
1. Dividend preference	a) Cumulative/noncumulative
	b) Rate
	c) When paid

2. Liquidation preference	a) Amount of preference b) Participating preferred c) Caps d) Treatment in mergers
3. Conversion	Price
4. Antidilution	a) Ratchet versus formula weighted average b) Broad-based versus narrowly based formula c) None; investor relies on rights of participation
5. Voting	a) Class vote b) Class versus series vote c) Level of consent d) Protective provisions/veto rights
6. Redemption	a) Mandatory/optional/none b) Initial date c) Redemption period
7. Registration rights	a) Threshold percentage of shareholdings to initiate a demand b) Minimum number of shares to include c) Maximum d) S-3 expenses and threshold e) Percentage in piggyback f) Expenses g) Transfer of rights h) Expiration i) Lockup
8. Preemptive rights	a) Limit to holdings in company b) Carve outs
9. Pay to play	Necessary with full ratchet
10. Cosale	Carve outs
11. Board representation	Number
12. Drag-along	a) Included b) Approval percentage
13. Stock option pool	a) Increase b) Premoney or postmoney
14. Founder/employee stock restrictions	a) Vesting b) Time/cliff/acceleration
15. Financing expenses	Amount of cap on fees

Investment Amount

Usually, the company won't be surprised at the investment amount when the term sheet arrives in their email inbox. In most cases, the VC and the company will have discussed the investment amount and the investors are aware of the funds the company is seeking. If the amount doesn't fit within the range of a typical investment for a fund, usually the venture partners will ask whether the entrepreneur is willing to increase or decrease the size of the round. If the entrepreneur isn't ready to change the amount of the financing,

the VC may politely end the discussions or may see whether the fund can invite another investor to fund the entire round.

ACCORDING TO VENTURE CAPITALISTS

How much dilution should you expect?

A typical company will see its shares diluted by 40% to 50% after a Series A round. Therefore, expect the capitalization table to resemble something like the following after your Series A financing: 40% founders, 40% outside investors (VCs), and 20% option pool.

Average equity ownership by outside investors:

- After the Series A round — 42.9%
- After the Series B round — 58.4%
- After the Series C round — 64.8%

Median dilution after a Series A round:

- Investment of less than \$5 million — 40%
- Investment of more than \$5 million — 50%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, September 2006 (based on information from 2004 to 2006).

Valuation

Perhaps the most fundamental issue in any financing is valuation. Valuation refers to the value of the company as established by agreement between the company and the investors. Investors typically refer to premoney valuation and postmoney valuation. Valuation is an art and the product of negotiation rather than a science.

Premoney valuation refers to the value of the company before the investment. It is calculated by multiplying (1) the price per share to be paid by the investors, and (2) the number of shares outstanding before the financing, calculated on a fully diluted basis so as to include the employee reserve pool. In the example given in the term sheet at the end of this chapter, the premoney valuation is \$4 million ($\$1.00 \text{ per share} \times [3 \text{ million founders} + 1 \text{ million employee reserve shares}]$).

Postmoney valuation refers to the value of the company immediately after the financing and is calculated by adding the amount of the new investment to the premoney valuation. The \$2.0 million financing of “High-Tech Startup Inc.” yields a post-money valuation of \$6.0 million.

The “Valuation” box below discusses a number of tools that investors and entrepreneurs can use to identify the respective valuation for a company. In addition, as a general rule of thumb, many professional investors will automatically apply a substantial discount (say 30%–50%) to the company’s valuation presented in the company’s initial business plan. This rule of thumb tends to serve to discount an entrepreneur’s oftentimes overly optimistic projections and should serve as a helpful guide to an entrepreneur as to what they should expect in early valuation negotiations.

ACCORDING TO VENTURE CAPITALISTS

What is the median company valuation for a financing?

Median premoney valuation (in millions):

	Series A	Series B
Quarter 1 of 2007	\$9.0	\$25.0
Quarter 2 of 2007	\$7.2	\$20.0

East Coast versus West Coast median premoney valuation 2006 to 2007 (in millions):

	Series A	Series B
East	\$6.0	\$10.0
West	\$9.0	\$28.0

Source: Private Company Financing Report, Cooley Godward Kronish LLP, 2006/2007.

VALUATION

Some industry experts will tell you that valuing an early-stage company is more a matter of intuition and experience than an actual empirical calculation (as discussed previously with the “30%–50% discount” rule of thumb). That said, there are a number of methods that an entrepreneur can look to for some guidance on the valuation figures to see whether the valuation is reasonable. Here are a few of the typical tools that VCs will use in their determination of a valuation:

- **Discounted cash flows:** Venture capital firms will often use a derivative of the discounted cash flows method to value the company. The approach estimates the earnings of the company at a point in the future where an exit is anticipated and then, using the price-to-earnings (P/E) ratio of comparable companies, determines the value of the company at that future point. Then, using a discount rate, the value of the company today is determined. Here are the steps to this valuation approach:
 1. Using the financial information provided to the potential investor, estimate the company’s net income or EBITDA at the point in the future where the investor will exit the investment.
 2. Looking at comparable companies with similar economic characteristics, determine an appropriate P/E ratio.
 3. Multiply the P/E ratio with the net income or EBITDA value to determine the value of the company at the expected liquidity event.
 4. Discount this future value to the present, generally using a rate in the range from 30% to 40% (but perhaps as high as 80%).

The obvious limitation of this method is the number of variables that can be changed slightly to change the entire calculation. Try various numbers in your calculations (including estimates on the high, middle, and lower end of your projections) to see the variations in valuation that will result.

- **Comparable valuations:** Comparison data about similarly situated companies can provide valuable information on appropriate valuations. Although the amount of funding for comparison companies is readily available on a variety of websites, including <http://CapitalHunter.com>, <http://GrowThinkResearch.com>, <http://LocalBusiness.com>, and <http://CapitalGrowth.com>, it is more difficult to obtain accurate valuation information. Your attorney may also have information on specific-industry deal points, including average valuation terms.

Some companies are now providing more specific information such as pre-money valuations. The Private Equity Data Center (<http://pedatacenter.com>) offers valuation information on companies for \$49.95 per company. VentureOne provides a "Comparable Valuations Report" analyzing comparable business fundraisings and valuations for \$1,295.00.

- **Comparable exit events:** An additional approach that may provide another data point in determining the appropriateness of a valuation figure is looking at exit events of comparable companies. To find comparable companies that have recent merger and acquisition activity, you can look in industry trade press or review local news sources. The Private Equity Hub (<http://PEHub.com>) provides news on exit events for venture-funded companies and has feature to search past news stories.

Thomson, in its database Venture Economics (<http://vx.thomsonib.com>), offers a paid subscription service tracking venture-funded merger and acquisition activity.

A VALUATION CALCULATOR

You've heard that coming up with a company valuation is an art. So how then can you tell whether the valuation you receive is even reasonable? Cayenne Consulting provides a free valuation calculator tool (<http://www.caycon.com/valuation.php>) to assist entrepreneurs and investors with the difficult process of determining an approximate range. Based on your responses to 25 questions (each questions has four potential responses), the tool will provide you a valuation ranging from \$0.5 million up to more than \$40 million.

Dividend Preference

A typical term sheet will include a noncumulative dividend on the preferred stock, usually set at between 8% and 10% of the purchase price per annum. Although initially this may seem heavy-handed ("You are trying to tell me that they want dividends too?!?"), in practice, dividends are rarely a point of negotiation. The truth is that very few private companies pay (and few investors ever expect to receive) dividends.

ACCORDING TO VENTURE CAPITALISTS							
Will the deal include cumulative dividends?							
Percentage of financings that include cumulative dividends:							
Q3'07	Q2'07	Q1'07	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05
4%	6%	8%	4%	7%	8%	3%	4%

Source: Venture Capital Survey, Silicon Valley Third Quarter 2007, Fenwick & West LLP.

Sometimes, investors will seek cumulative dividends. Generally, these are not intended to be paid in cash because the startup company needs the cash. However, cumulative dividends may be paid in connection with a redemption or at the time of a merger, or, in the event of a public offering, would be added as a premium to the rate at which shares of preferred stock are converted into common stock (this rate is usually 1:1 at the time of the financing). Cumulative dividends can significantly increase the value of the investor’s security, but they can also pose tax problems for the investor. As a practical matter, cumulative dividends aren’t frequently requested. Dividends aren’t a highly negotiated portion of the term sheet, although there may be some discussion regarding cumulative versus noncumulative dividends.

Liquidation Preference

The vast majority of term sheets will include a liquidation preference for the preferred stock, basically ensuring that the investors are paid out first if the company dissolves or is liquidated through a merger or acquisition. Nearly all venture financings have a liquidation preference, but there will often be negotiation around the details of how the preference works.

A liquidation preference comes into play in one of two situations: (1) the company fails and has to sell the remaining assets and liquidate the business, or (2) the company is acquired by or sold to another company (or also a merger transaction in which the current shareholders wind up no longer owning the company). In each of these cases, the shares will end up liquidated, and it will need to determine how to divide the proceeds from the transactions. The liquidation preference for the investors ensures that the investors are the shareholders that will be paid back first, allowing the investor to recoup their initial investment (and perhaps more). Then, after the preference is paid, any proceeds that remain will be allocated proportionally to the common stockholders.

As an example of why this provision matters, consider the following hypothetical. Company A raises \$6 million on a \$6 million premoney valuation for a postmoney valuation of \$12 million. Now the founders of Company A own 50% of the company, and the investors own the other 50% in preferred stock. One year after the financing, an offer is made by a third party to buy the company for \$10 million. In this simple example (and absent any liquidation preference), the founders would get \$5 million of the proceeds (50% of \$10 million) and the investors would get the other \$5 million. Do you see the problem here? On this transaction, the investor just lost \$1 million, whereas the founders just made \$5 million. That’s not a great business model, is it? So to prevent this from occurring, the investor will require a liquidation preference. This insures that the Series A investors get paid back first—their full \$6 million investment—before anyone else gets paid.

This is the reason the liquidation preference is typically the most important economic right of the preferred stock (and the major reason why it is usually valued higher than the common stock, as discussed previously). Having this liquidation preference ensures that, even if things sour, the investors are going to be paid back first. Generally, the liquidation preference is written in such a way that preferred shareholders receive their purchase price before any payment to common shareholders in the event of a liquidation or dissolution of the company and, usually, also in the context of a merger or other acquisition of the company.

ACCORDING TO VENTURE CAPITALISTS

What should you expect for liquidation preferences?

Percentage of Series A deals that have liquidation preferences: 97%

Series A	Series B	Series C	Series D
97%	98%	100%	99%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, August 2007.

However, there is still more to the concept of a liquidation preference. The rest of the discussion focuses on what happens when liquidation occurs, making the stockholders lots of money. How are the proceeds divided and who gets what first?

Preference Multiples

In some cases, the liquidation preference may be greater than just the return of the investor's initial investment, sometimes two or three times the investor's initial investment. This is referred to as a preference multiple. In this case, in the event of a sale or liquidation of the company, the investor will first receive two or three times its initial investment before the remaining funds are distributed.

ACCORDING TO VENTURE CAPITALISTS

What should you expect for liquidation preference multiples?

Percentage of Series A deals that have 1× liquidation preferences: 91%

	Series A	Series B	Series C	Series D
1×	91%	85%	87%	77%
1–2×	4%	10%	10%	17%
2–3×	2%	1%	2%	1%
Greater than 3×	0%	2%	1%	4%
None	3%	2%	0%	1%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, August 2007.

Here is the example of preference multiples at play. This time, Company A again raises \$6 million on a \$6 million premoney valuation for a total valuation of \$12 million post-money. The investors have a three times (3×) preference multiple, meaning that they would receive \$18 million back in a liquidation or sale event, before any other shareholders are paid. One year later, the company receives an offer to buy the company for \$20 million. The investors hold a three times preference on nonparticipating preferred stock (see below for the difference between nonparticipating and participating). Now, after the liquidation, the investors will receive their \$18 million (the initial \$6 million investment × 3), leaving \$2 million to be allocated among the common stockholders.

The difference between using a one-time liquidation preference multiple and a three-times preference multiple equates to \$8 million of additional proceeds as a result of the investors on this \$20 million transaction (\$18 million versus \$10 million if the preferred converted into common and received 50% of the proceeds).

Participating Preferred Stock

In some transactions, after the preferred stock receives their initial liquidation preference (one, two, three times or more), then they also receive the right to receive a portion of the remaining proceeds. Enter the concept of participating preferred stock. In the event of liquidation such as a sale of the company, the liquidation preference ensures that the preferred stock is paid back first (or paid back two or three times). However (and here's the kicker), participating preferred stock are then entitled to share (participate) with the common stockholders in the remainder of the proceeds.

Here is the example of participating preferred at play. This time, Company A gets an outstanding offer to sell the company for \$20 million just a year after receiving funding. The investors hold participating preferred stock. This means that the investors will first receive their \$6 million back, leaving \$14 million to be allocated. Now, the preferred will participate based on their ownership (here 50/50) in the remaining amount, with \$7 million going to each. So the investors receive \$13 million and the founders receive \$7 million of the \$20 million purchase price. If the investors had held nonparticipating preferred stock, then the investors would have a choice: (1) exercise the liquidation preference and receive only \$6 million, or (2) convert the preferred stock into common stock and take their portion (\$10 million).

The difference between using participating and nonparticipating preferred stock in the term sheet was \$3 million for the investors (\$13 million versus \$10 million) and the reason that understanding a liquidation preference matters.

So hopefully you can now see why participation rights are a major negotiating point in venture financings. A nonparticipating preferred effectively requires that the preferred shareholders elect whether to retain their preferred stock and receive only their purchase price or convert their preferred stock to common stock to share in the proceeds remaining after payment is made to any nonconverted preferred stock. Participating preferred shareholders receive their original purchase price and then participate with the common shareholders in the distribution of the balance of the remaining proceeds.

Capped Participating Preferred

Based on the previous examples of preference multiples and participating preferred stock, it may seem that these terms are unfair. That's not exactly the case. Historically, most venture deals involved a nonparticipating preferred stock. In recent years, however, many investors have insisted on a participating preferred to avoid the situation wherein the company

is acquired for approximately the postfinancing valuation (i.e., there is no appreciation in the value of the company) and (1) the preferred shareholders receive their invested amount but no return, and (2) the common shareholders receive a substantial return based on their lower cost basis. In negotiating this point, the company would argue that the investors should not expect a return if the company does not appreciate in value and that the investors should not be paid on the front end (the initial preference payment) and the back end (the distribution of the remaining proceeds) if the company is successful.

As a result, use of capped participating preferred has become much more common. With capped participating preferred, the preferred stock will be participating in mergers in which the return to the preferred shareholders would be less than a fixed multiple of the purchase price (typically between two and five times) on a straight pro rata sharing and nonparticipating in mergers resulting in proceeds above that price point.

Capped participating preferred is meant to reward everyone equally when the company has a very successful sale or merger event. At an acquisition above the “cap” price, investors would convert their preferred stock into common stock and share the distributed assets pro rata with all other holders. However, if the event is a medium success, the investors will receive a greater portion of the proceeds.

ACCORDING TO VENTURE CAPITALISTS

How likely is participating preferred and what are typical caps on participating preferred stock?

Only 50% of Series A financings have participating preferred. Of those 50%, half (25% of the total) have uncapped participation rights, whereas the other half (25% of the total) have caps at various levels.

	Series A	Series B
No participation beyond 1× liquidation preference	50%	41%
1–2×	7%	10%
2–3×	13%	13%
Greater than 3×	5%	4%
Uncapped (full participation)	25%	32%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, November, 2007 (based on financing transactions in the second quarter of 2007).

Here is the example of capped participating preferred at play. Again, Company A gets an outstanding offer after the first year to sell the company for \$20 million. As before, the investors hold participating preferred stock with a one-time preference multiple, but this time there is a cap set at four times the original purchase price (often this also includes dividends, but we’ll skip that here). So, if the management decided to take this deal, the investors would get \$13 million (\$6 million from the one-time liquidation preference and then 50% of the remaining \$14 million) and the founders would get \$7 million (their half of the \$14 million after the initial \$6 million to the investors). Although this would be a nice result, management believes there is more to the company and rejects the merger.

Fast forward to two years later. The company has taken off like a rocket and now receives an offer from a new suitor to purchase the company for \$60 million. Because of the cap,

the investors now have a choice. They can (1) take \$24 million, which is four times their original purchase price and no more, or (2) convert their stock into common and receive \$30 million, half of the total proceeds from the sale. Without the cap, the investors would receive \$33 million (\$6 million from the one-time liquidation preference and then 50% of whatever remains) and the founders \$27 million (their half of the \$54 remaining after the \$6 million from the liquidation preference). Use of the capped participating preferred may provide for better alignment of priority among the investors and founders.

Special Shareholder Returns

In the alternative for companies that do not have a cap on participation, management often seeks a special return when its efforts have generated added value for investors (e.g., a two-fold to fourfold return on the investment in which the liquidation event is a merger rather than a winding up of the business). This is oftentimes done to offset some of the preference rights of the investors in a highly successful event. Accordingly, some financings now include a liquidation payment to the common holders (e.g., \$0.25 per share) before commencement of the “participating” preferred distribution.

Automatic Conversion

Preferred stock will generally have a voluntary conversion right, permitting any holder of preferred stock to convert their preferred shares into common shares at any time. However, the automatic conversion refers to certain situations in which the preferred stock will automatically convert. The events that will initiate the automatic conversion are usually (1) a vote by the majority or supermajority of all the preferred stockholders voting as a single class (sometimes each separate class will need to approve), or (2) a qualified IPO meeting certain agreed-on criteria.

The terms of the conversion can be quite confusing, but the general fact is that preferred stock will initially convert on a 1:1 basis into common stock. However, based on future financing events and other factors built into the conversion ratio, preferred stock may be converted at varying rates into common stock.

The primary reason that these conversion rights are built into the preferred stock is to force the preferred holders to convert their stock into common immediately before an IPO. As a result of the conversion, most of the negotiated rights and preferences of the preferred stock will disappear, creating a simple capitalization structure before the company goes public. Most underwriters will require that outstanding preferred stock convert to common stock in the event of an IPO. To avoid the need to negotiate this conversion at the time of an IPO, the company will negotiate a trigger price. Automatic conversion at three times the purchase price would be ideal for the company in a first-round financing, but it is likely that investors will expect an automatic conversion price of four to five times their purchase price.

Although the automatic conversion itself is rarely negotiated, the criteria for a “qualified” IPO may be negotiated as a part of the term sheet or during the document drafting process. These criteria require that the initial public offering be priced at a minimum per share price (generally set at two to five times the purchase price of the convertible preferred) and for a minimum aggregate amount of dollars raised by the company in the offering. The minimum aggregate offering amount is often set at \$7.5 million (the minimum amount currently required for registration on Form S-1), but the investors may request a higher threshold (\$10 million to \$15 million). This requirement is intended to ensure that there will be adequate “float” (shares held by public investors) after the IPO.

Antidilution

Dilution prevention provisions are designed to protect the investor from dilution that may occur in subsequent financings in which stock is sold at a price lower than the investor originally paid. The antidilution formula provides for an increase in the conversion rate of the preferred stock (and therefore a lower effective per share price on a common stock equivalent basis) in the event of a subsequent financing at a price less than that paid for the preferred stock being adjusted. A future financing sold at a price lower than in the previous round is called a “down round” or a “washout financing” (see the textbox at the end of the chapter that discusses washout financings). Down rounds occur more frequently than you might think (approximately 20% of financings each year are down rounds). As a result, investors will generally insist on antidilution provisions to prevent dilution in the event of a future down round.

The question that entrepreneurs don't always ask is this: If the investors are protected from dilution in a down round, what happens to the rest of the company? Unfortunately, the common stockholders are the ones who will be affected the most. Common stockholders are actually diluted twice in a down round: first the normal dilution from raising additional funds and then additional dilution to cover the dilution that occurred to the investors as a result of the antidilution provisions.

Although nearly all venture financings will include an antidilution provision, the primary point of negotiation will focus on the formula to use. In most venture financings, a weighted-average adjustment is a more common type of antidilution protection over the full-ratchet adjustment, which tends to have a more severe effect on the common shareholders.

Weighted Average

Weighted average antidilution is not as severe as the full-ratchet antidilution provision discussed below. Instead of repricing the previous rounds at the same price of the down round, the weighted average dilution reduces the conversion price based on the investor's ratio of stock owned to the total amount of stock of the company. Using this provision will decrease or limit dilution in a down round for the investor but will not prevent it entirely.

There are two different types of weighted average calculations: broad based and narrow based, with broad based being the more frequently used calculation. The primary difference between these terms lies in the way “common stock outstanding” is defined.

Under the broad-based provision, both of the following are included: (1) the current number of common stock outstanding (which would include the number of shares of common stock that would be issued in a full conversion of all preferred stock), and (2) the number of shares of common stock that would be issued from the conversion of all options, stock rights, warrants, and other securities.

The narrow-based weighted average formula would not include the convertible securities in option 2, only using the current outstanding securities.

Full Ratchet

Full-ratchet dilution protection gives investors the ability to recalibrate a per share purchase price downward to the price at which shares are sold in the next round of financing. As an example, assume the first-round investor paid \$1 per share to own 10% of the company. In a later down round priced at \$0.50 per share, the investor's shares would be repriced to \$0.50 per share. The investor wouldn't receive additional shares of preferred stock, but the conversion rate would be adjusted to double the number of shares of common stock that the investor would receive if the investor were to convert the shares. This

would ultimately increase the dilution on the common stockholders. This provision then allows the investor to maintain the ownership percentage in the company.

If the company does provide a ratchet adjustment, the company should consider asking that the investors be required to participate in future dilutive financing or lose all antidilution protection: the so-called “pay-to-play” feature (discussed further below). The problem for the company with full-ratchet dilution protection without the pay-to-play feature is that the ratchet protection eliminates an incentive to participate in subsequent dilutive financings because an investor can receive the benefit of the adjustment without putting additional money at risk.

ACCORDING TO VENTURE CAPITALISTS

What type of antidilution formula should I expect?

	Series A	Series B	Series C	Series D
None	6%	5%	5%	5%
Broad-based weighted average	83%	85%	80%	77%
Narrow-based weighted average	3%	3%	6%	2%
Ratchet	8%	7%	9%	16%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, April 2006 (based on financing transactions in 2004–2005).

Some investors will offer a derivative of the full ratchet called a “partial ratchet,” including a “half ratchet” or “two-thirds ratchets.” The concept is similar to a full ratchet but will have less of an impact on the common holders. However, these provisions are fairly uncommon.

One other wrinkle on antidilution clauses is the pay-to-play provisions, which require the investors to participate in the dilutive round to receive antidilution protection with respect to their higher-priced preferred stock.

ACCORDING TO VENTURE CAPITALISTS

What percentage of financings have “pay-to-play” provisions?

Series A	Series B	Series C	Series D
13%	15%	22%	27%

% with Pay-to-play	
Quarter 2 of 2007	14%
Quarter 1 of 2007	9%
Quarter 4 of 2006	11%
Quarter 3 of 2006	8%
Quarter 2 of 2006	11%
Quarter 1 of 2006	13%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, November 2007 (by quarter), April 2006 (by series, transactions from 2004 to 2005).

Preemptive Rights

In addition to the provisions discussed previously to limit dilution, investors will often request preemptive rights or a right of first refusal as a tool to allow the investor to maintain its ownership percentage. Preemptive rights will generally involve a contractual right to purchase additional shares in the company's next offering to maintain the investor's percentage shareholdings, usually the pro rata share. However, in some cases, the provisions provide that the investor has the right to purchase any future shares the company will issue, even in excess of their pro rata amount.

Preemptive rights can cause some complications for a company raising additional funds, because the company must offer a portion of the additional investment to its current holders, which can raise certain hurdles in adding a strategic investor or a new investor. As a result, if the investor requires preemptive rights, it is usually in the interest of the company to try to limit this right to only the purchase of a portion of the shares offered in the next round sufficient to maintain an investor's prefinancing shareholdings on a fully diluted basis. Preemptive rights should include language terminating the right before an IPO to prevent any problems that would result in a general sale of securities.

One key point on the right of first offer is to preserve the company's flexibility to engage in transactions such as equipment lease lines with warrant coverage without having to get waivers from the investor group.

Board Representation

VCs will almost always have at least some representation on the company's board of directors: usually, the lead investor or investors of the round will receive a board seat as a result of their investment. This role within the company should be welcomed because a well-connected and experienced director from your venture fund can offer insight, industry knowledge, and key contacts. However, depending on the size of the investment and the number of investors, the investors may control a majority of the board after their investment. In the transaction, the parties will typically determine that the new series of preferred stock (or all of the preferred stock as a class) will have specific voting rights with respect to the election of directors that vary from the one-share-one-vote rule set forth in the certificate or articles of incorporation.

A key point of negotiation will center on issues on the overall board composition. For example, before a Series A investment, the company may have a three-director board that will be expanded to four or five directors (with one or two investor designees) after the closing of the transaction financing. In the event that management is concerned about a losing control over its board, the company may want to consider the size of the investment or insist on additional board members to be elected by the common stockholders.

LIMITATIONS OF BOARD REPRESENTATIVES

Expect the board representatives from the venture capital firm to be busy. According to the National Venture Capital Association, the average number of company boards that a VC sits on is four. Understand the limitations that a partner of a venture capital firm will have if he serves on multiple boards in addition to your company.

In the case in which an investor does not hold a majority of a series of preferred stock, the investor will often receive board observer rights to permit the investor to designate an individual to observe the board meetings but not hold a vote. Additionally, investors may also negotiate for certain informational rights to receive financial statements and other company documentation on a monthly or quarterly basis.

Voting Rights

Venture preferred stock typically has voting rights, computed based on the number of shares of common stock into which the preferred stock can be converted. In addition, the preferred shareholders will be entitled to a class vote as a matter of corporation law under certain circumstances, such as certain merger situations.

In addition to the rights above, the investors will typically negotiate for veto rights over certain actions of the corporation. These veto rights are also known as protective provisions, approval rights, or negative covenants. Usually, the investors will negotiate for the right to approve the following:

1. Any merger or acquisition of the company irrespective of whether state corporation law grants them such a right
2. The creation of any new securities senior to or on a parity with their preferred stock
3. Any amendment to the articles of incorporation that would affect the rights of the preferred stock
4. Changes to any of the rights and preferences agreed to in the preferred stock sale

Although the protective provisions mentioned above are usually included in the transaction agreements, both parties may disagree on the addition of other provisions such as those discussed below.

The investors will likely want a separate vote of the preferred stockholders on some matters in which such a vote is not required by law. In situations in which the investors are acquiring a minority position in the company, and as such cannot control the board of directors, the investors may also attempt to negotiate the right to approve the following:

- Any sale, merger, or acquisition of the company
- Purchasing stock of another business
- Certain other corporate transactions, such as the sale of a product line
- The sale or an exclusive license of significant technology
- Purchase of assets over a certain dollar threshold
- Incurring debt
- The issuance of any new securities senior to or equal to the preferred stock
- Redemption of stock
- Increases in management's cash compensation beyond historical practice
- Additional stock or option grants to management
- Other points negotiated by the parties

These items listed above are typically more negotiable than items 1–4 in the preceding paragraph. Therefore, these provisions tend to be more negotiated by the parties. Some of

these items may tend to fall into the traditional decision-making realm of management and the board of directors. In the event these veto rights encroach too far into management's responsibilities, you should attempt to negotiate those provisions away.

These veto rights in the event of specified events or protective provisions in the form of special voting rights of preferred stock holders are often (but not always) included in the term sheet. From the company's perspective, it is preferable to have a class vote (e.g., Series A and B voting together) rather than a series vote.

Redemptive Rights

The term sheet may include a provision to require the company to redeem (buy back at the original purchase price plus an annual carrying cost) the preferred stock. Investors sometimes seek redemption rights as a way of obtaining a return on their investment if the company does not go public or get acquired. Redemption provisions are fairly common in transactions, although mandatory redemption provisions are somewhat rare. Generally, in transactions that include redemption provisions, the majority will have a redemption provision at the option of the investor. Typically, redemption occurs over three or four years beginning five years after the financing, although some investors insist on total redemption all at once.

A redemption feature allows the company to retire the preferred stock after a specified period of time (typically between five and seven years) by paying the purchase price and, possibly, a small premium (although anything more than 10% of the purchase price creates potential tax problems for the investors). A redemption call effectively requires the preferred shareholders to elect whether to receive their investment and little or no return, with a corresponding loss of the opportunity cost of having their money tied up for a number of years, or converting their shares into common stock, with a loss of their preferential rights. In the case in which the investors see little hope of a successful exit for the company after a fairly long investment period, the redemption feature may be an attractive alternative for a venture fund.

Mandatory redemption is more commonly requested by investors who are taking a minority position in the company. For these investors who may not have a strong position through the board or as a major stockholder, the notion is that the mandatory redemption feature will allow them to get their money out in the event the company becomes one of the "living dead" (i.e., no real prospects for going public or being acquired). Mandatory redemption is disadvantageous from the company's standpoint because of the potential for a significant outflow of cash. In this regard, if a mandatory redemption feature has to be included to get the deal done, a staged payout, perhaps spanning a three-year period, is often negotiated.

ACCORDING TO VENTURE CAPITALISTS

Will the deal include redemption provisions?

Percentage of financings that include mandatory redemption or redemption at the option of the VC:

Q3'07	Q2'07	Q1'07	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05
26%	22%	26%	22%	29%	33%	27%	31%

Source: Venture Capital Survey, Silicon Valley Third Quarter 2007, Fenwick & West. LLP

With the exception of mandatory redemption clauses, the redemption feature, like the dividend provisions, tends not to be controversial. As a practical matter, use of the redemption provision is quite rare, particularly for companies within California, because (1) California corporate law prohibits payments to shareholders unless certain liquidity tests are met, and (2) a company that can meet the liquidity tests is probably strong enough from a financial standpoint to go public or be acquired at a favorable valuation.

Cosale Rights

To prevent a situation in which, after an investment, the founders jump ship and sell their shares to a third-party investor, most venture financings will include a cosale right. The cosale right gives the investor the right to sell its shares on the same terms as the investors, usually on a pro rata basis of its total ownership percentage in relation to the total sale.

More specifically, cosale rights, sometimes called tag-along rights, are the right to participate in any pre-IPO sale by the founders in proportion to the relative number of shares owned by the founders and the investors. In a company in which a founder controls a majority of the company, the investors will often request cosale rights. As a practical matter, the cosale right will limit the incentive and ability of the founders to dispose of a significant portion of their holdings in the company before the IPO. However, because the opportunities for separate liquidity for founders generally tend to be limited, cosale rights are not generally viewed to be significantly disadvantageous to founders in most situations and are less likely to be negotiated than other more meaningful terms, such as vesting on founders' shares.

Investors may want to participate in any pre-IPO stock sale by the founders. Cosale rights, if exercised, will result in less money to you on a private stock sale, and the notice and other requirements of a cosale right may impede a sale. Nevertheless, because the investors want to use equity to direct the company's management toward a long-term return rather than an early cash out, they are likely to insist on a cosale right.

Cosale rights are common in venture investments and typically will offer exceptions for certain types of transfers, such as for small amounts of stock, sales, or transfers to family members, or sales in the event of termination of employment or death of the founders. In addition, the cosale rights will often be accompanied by a right of first refusal for the investors. With a right of first refusal, founders will be restricted from selling their shares to any third party without first offering the shares to the company and/or the investors. The shares will be offered on the same terms as given to the proposed third-party purchaser.

Drag-Along Rights

The primary purpose of drag-along rights are to ensure that the investor's shares won't be held hostage in the event of a favorable acquisition or merger event. Drag-along rights permit the holder of the rights to force the other shareholders to sell their shares if there is a third-party offer for the purchase of the company that has been approved by a certain percentage of the shareholders, usually a majority or a supermajority such as 70 or 80%. The reason this right is important to investors is that many acquirers will not purchase a company unless they are able to acquire all outstanding stock of the company. If a few shareholders hold out approving the transaction, the drag-along rights will permit the investor to force a sale by the holdouts.

ACCORDING TO VENTURE CAPITALISTS

Will the deal include a drag-along provision?

Series A	Series B	Series C	Series D
48%	46%	42%	42%

Source: Private Company Financing Report, Cooley Godward Kronish LLP, April 2006 (based on financing transactions from 2004 and 2005).

Registration Rights

Registration rights are an important right to investors because they provide a contractual right for investors to demand that the company register their shares with the SEC. After a registration, the investor can sell their shares on the public market. The importance of this right stems from the U.S. securities laws that permit the company, and not the shareholder, to register the company securities. To ensure that liquidity will eventually become an option for the investor, registration rights are negotiated as a part of the purchase.

Investors are typically granted certain registration rights from their transaction, consisting of demand rights (the right to require the company to register their shares with the SEC), "piggyback" rights (the right to include their securities in the company's offerings registered with the SEC), and S-3 rights (the right to require the company to register their shares on the SEC's short-form registration statement; this applies only after the company has been public for one year and meets certain other tests).

Demand Registrations

Registration on Form S-1 is an expensive and time-consuming process. Therefore, the demand registration rights can be a very burdensome obligation for the company. Usually, the demand registration rights may not be exercised for three to seven years after the preferred stock purchase. If the company does make a registration on its own earlier than the three to five year minimum, there is generally a three to six month time period after the IPO until the investors can make their demand. From a company's perspective, the time limitations for the demand rights should be set at a reasonable time in the future to prevent the investors from requiring the company to go public before management and the company is convinced the company does represent an IPO candidate. In most cases, the shares that can be registered must (1) represent a specified percentage (perhaps as low as 20% and as high as two-thirds of the outstanding securities), or (2) their value must equal a minimum specified dollar amount (usually \$5 million to \$25 million). These limits are set to ensure that enough shares will be registered to make the effort and cost of the offering worthwhile. The company will usually limit the number of permitted demand registrations to a maximum of three.

S-3 Registrations

A registration on Form S-3 is generally much less expensive and time consuming than registration on Form S-1 (because this filing can incorporate information from previous filings with the SEC). As a result, the company will often grant unlimited S-3 registrations

on request of holders of a minimum percentage of the shares that can be registered, oftentimes 20–30%. However, the S-3 registration right will usually be limited to one or two registrations in a single one-year period. As with demand registrations on Form S-1, some companies will negotiate to limit the total number of S-3 registrations.

Piggyback Rights

Piggyback rights permit the investor to participate in a public offering of securities by the company. These rights are not usually unlimited, providing the underwriters with the ability to limit the amount of shares that can be registered for sale if it will influence the public sale. These rights are generally fairly noncontroversial.

In addition to the registration and piggyback rights, the registration rights provisions oftentimes include information on responsibility of filing fees and transfer restrictions on registration rights. One key point on registration rights is to ensure that they terminate at some point after the company's IPO or when the investors can sell their shares under SEC Rule 144. Typical registration rights will provide the investor with two demand registrations that may be brought at any time commencing three to five years after the investment, along with piggyback registration rights for company offerings.

Financing Expenses

Typically with venture capital investments, the company will pay the legal expenses of the attorney for the investors; generally, the investors will select a single attorney to represent all the investors if multiple investors are part of the syndicate. The company's counsel nearly always prepares the financing documents. The advantage to the company of this arrangement is twofold. The financing can be closed more quickly because company counsel can deliver the initial document package shortly after agreement on a term sheet and as draftsman can better control the timing thereafter. As a result, the financing should be accomplished less expensively.

The company often pays the legal fees of both its own counsel and counsel, if any, for the investors (which typically is paid from the financing proceeds). A cap on legal fees for investors' counsel is often established and runs in the range of \$15,000 to \$35,000. Anywhere from \$15,000 to \$35,000 is typical, depending on the complexity of the transaction (for example, a Series A financing for a new startup will likely be more expensive than a Series E with a bridge loan and warrants for a long-established company) and which side will bear primary drafting responsibility. Some companies are able to negotiate that the payment of expenses is contingent on the consummation of the financing; however, this is not a typical practice.

Employee Stock Option Pool

Investors will usually insist on the company setting aside additional shares of stock or option grants for future hires. Moreover, this employee reserve will be assumed to be fully issued for purposes of setting the per share price for the venture investors. The size of the employee reserve will depend primarily on the perceived staffing needs of the company during the succeeding year or two. If the investors believe that a number of high-level employees must be hired, they may insist on a substantial reserve.

Employees in venture-backed companies who receive stock grants are almost invariably put on a vesting schedule. A typical vesting arrangement would often provide for a

four-year schedule, with no shares vesting during an initial period of between six months and one year (a cliff). At the end of the probationary period, the employee would become vested in the same number of shares as if he had been on a linear schedule, with the remaining shares vesting in equal monthly installments.

Founders and Employee Stock Restrictions

Many sophisticated venture investors will ask that the shares held by founders and employees be subject to forfeiture on departing the company, with specified percentages becoming vested against forfeiture over time. There is no set custom on this; where you come out will depend in large part on your relative bargaining strength with the investor. Even in cases in which the founders have previously imposed some type of vesting schedule on their stock, the investors may require the schedule to be modified and acceleration provisions to be reset. The addition of these provisions will typically involve the founders entering into individual stock restriction agreements with the company as a condition to closing.

If the founders are subjected to a vesting schedule, there are a number of ways it could be negotiated to lessen its impact. For example, the vesting might cover only a portion of your shares, the vesting period might be relatively short (one or two years), you might receive credit for previous performance, and the repurchase right might only arise if you voluntarily terminate your employment or if your employment is terminated for cause. In the event the founders have previously subjected the founders stock to vesting terms, some investors will simply continue the vesting (or modify it in some capacity). However, generally an investor will want to ensure that the length of vesting is adequate to ensure that the founder is incentivized to continue with the business for a set period of time, typically between three and four years.

One important item that is oftentimes negotiated in the context of founder and employee vesting are acceleration provisions. Acceleration is primarily discussed in cases of a change of control, an event such as a merger or sale. In the event of a change of control event, usually two different approaches to acceleration are discussed:

- **Single trigger:** In the event of a qualified change of control (the trigger), the options held by the founder or employee will be accelerated. In some cases, all option will be accelerated or a portion may be accelerated.
- **Double trigger:** This acceleration is triggered when (1) there is a change of control event, and (2) the employment of the individual is terminated without cause.
- **Combination approach:** In this case, a portion of the options may be accelerated in the event of a change of control (say, 25% of the unvested option) and the remaining options will be accelerated in the event of a termination after a change of control (the double trigger).

In some cases, acceleration may also be given in the event of termination of the employee without cause (not in conjunction with a change of control event), to prevent a scenario in which members of the management team are terminated by the board of directors to bring in a more seasoned management team.

Other Possible Terms

No-shop provisions limit the ability of the company to solicit competing term sheets from other investors. A No-talk provision is a similar restriction but extends to negotiations

with any rival investors. Usually these limitations will be restricted to a 30-day period, after which the restriction will no longer apply. Interestingly, unless there is a fee for terminating the deal (which is rare in VC financings), there is usually not a remedy for the breach of these provisions included in the term sheet.

Information rights or rights to financial information are fairly standard provisions. Generally, the only negotiation will center on the frequency or scope of the information, limiting the information rights to information that is usually prepared in the course of business (standard financial statements or other standard reports) and within the standard scope of materials reviewed by the board or other investors (not materials under the purview of management). In addition, information rights that provide the investor with unannounced access to the company can create an unmanageable relationship for the company.

Confidentiality agreements, such as a nondisclosure agreement, will generally not be signed by an investor during the financing process. However, investors may be willing to provide for confidentiality and nondisclosure at the time the term sheet is signed.

The following is a list of other terms sometimes incorporated into term sheets but which tend to be much more unusual than any of the prior terms discussed. For the most part, these terms are considered to be investor-favorable.

- Mandatory redemption (holders have the option to require the company to repurchase after a certain date, such as five years after the initial investment)
- Increased pro rata rights in follow-on rounds (one and a half to two times pro rata rights in any additional rounds to allow investors to increase ownership percentages)
- Most favored nation for future financing (guaranteeing terms for the initial investor that are equal to or better than any follow-on investors)
- Required sale provisions (company is required to liquidate if there is no initial public offering before a certain date, such as five years after the initial investment)
- Warrant coverage (usually associated with an investment round that has the same or similar price to a previous round)
- Increase in the size of the stock option pool on a premoney basis
- Payment of funds only on the achievement of certain company milestones
- Mandatory cumulative dividends
- Requiring the founders to individually make representations and warranties (often in the case of intellectual property matters)
- Investment takes the form of convertible debt rather than equity
- Preferred stock options for management (this is promanagement to better align investor and management incentives and is generally done when common shares become highly diluted or preferred have vastly superior rights)

In the case of the items above, many of these terms are more typical in a period of tighter venture money supply, in which the investor has greater leverage. Depending on market conditions, these terms may be more common as investors recognize an increased need to protect their initial investments.

VALUATION FIXATION

What could happen

You've narrowed the list of potential investors for your company to four firms. The range of premoney valuations is fairly large. Shouldn't you just select the firm with the largest premoney valuation (to reduce the dilution)? Doesn't a high premoney valuation mean that firm "gets" your business and understands the long-term potential?

Watch out for

A high valuation doesn't necessarily mean a good deal for your company. A company should consider the impact of additional terms, including the time period of redemption rights exercisable, the use of participating preferred with a cumulative dividend, as well as ratchet antidilution protection without a cap. You should discuss the entire term sheet with someone experienced in VC deals, such as other entrepreneurs, members of investor forums, or your attorney. Model out the impact of these additional terms on future events such as a sale, IPO, or other liquidation event, each at various proceeds levels for the company.

It is also important to consider the differences in the firms themselves when selecting an investor for your company. Look to other portfolio companies and the founders of those companies. Look at the industry expertise. Look at the location. Remember that, in addition to your money, the investors play an important role on your board and can be a source of important contacts for new hires, customers, and collaborators. A high valuation from a firm that is not a good fit won't be the best partnership.

TIP: Consider the entire term sheet and research the investor firm before selecting your investment partner.

Deal Documents in a VC Financing

Signing the term sheet is the first step in closing the venture capital financing. Expect several weeks (or more depending on the time it takes you to provide legal due diligence to investor's counsel and the time they need to review it) from the term sheet signing until the closing of the investment. Generally, after consultation with your attorney, you should set a targeted closing date for the investment to push the process forward.

Every year, at a minimum, thousands of venture financing deals of private companies occur. Countless hours of preparation, negotiation, and drafting of investment documentation occurs. Nevertheless, venture capital financing documents tend to consist of a fairly standard set of terms and documents given the recurring issues that arise. The most common venture capital financing documents include a term sheet, a certificate or articles of incorporation, a stock purchase agreement, an investors' rights agreement, a right of first refusal and cosale agreement, a voting agreement, and various ancillary documents. Transaction documents may vary depending on the venture capital firm, the stage of the company, and the location of the venture capital firm.

Familiarity with the documents that will be a part of the transaction will help the entrepreneur understand the steps and discussions taking place between your attorney and the investor's counsel.

Term Sheet

As discussed previously, a term sheet is the document outlining the material terms and conditions of a business agreement. After the term sheet has been executed, it can be used as a template to create the final set of venture financing agreements. The term sheet itself guides the agreement but is not necessarily binding. Many of the terms not present in the term sheet are standard industry conditions that present less significant negotiating obstacles.

SEALING THE DEAL (WHAT YOU'LL NEED TO PROVIDE IN DUE DILIGENCE)

What could happen

You've found a source of funds, which may be a traditional venture capital firm, a bank loan, or a corporate partnership of some form. They are prepared to invest and have told you "now it is time for the lawyers to become involved."

What to expect

Traditionally, you and your attorney can expect to receive a due diligence request list. This will include a list of items you'll be expected to produce. Some of the items may be held by your attorney or accountant, but others may be in your control. The following represents a high-level summary of information you would typically expect to be asked to provide:

1. **Business plan backup:** Details of financial projections; backup data and information for key assumptions; sources for any third-party data; and more detailed information related to the use of proceeds
2. **Employment information:** All employment paperwork for key employees; invention assignment agreements; noncompetition agreements; confidentiality agreements; severance provisions for management; references for the CEO, current board members, and key managers
3. **Corporate documentation:** All corporate formation documentation; state filings; copies of board and shareholder minutes or resolutions; evidence of proper corporate filings; share issuances; option plans, option grants and option exercises; all corporate security issuances and evidence of compliance with securities laws
4. **Intellectual property:** Patents; trademarks; copyrights; filings with state or federal agencies; communications with the patent office; license agreements; information disclosure statements; trade secrets; internal policies for company intellectual property; invention assignment agreements; open source licenses (if applicable); copies of all nondisclosure agreements
5. **Market information:** Customer records and agreements; letters of intents for potential customers; channel partners; testimonials; reports from third parties; research data and source data

6. Research, development, and engineering: Product information; specifications; product documentation; performance data; beta tests and results; test data; benchmarking; industry research

TIP: Instill a culture of recordkeeping and maintain proper corporate governance records to make the due diligence process run smoothly.

Certificate of Incorporation/Articles of Incorporation

The certificate/articles of incorporation is a legal document relating to the formation of a company or corporation. It contains basic provisions detailing the corporate name, registered address and agent, statement of purpose, and other relevant information about the business's identity. After a preferred financing, however, the certificate is amended to include the terms of the preferred stock, including the number of shares, dividend payments, liquidation preferences, redemption, conversion rights, and voting rights.

Stock Purchase Agreement

A stock purchase agreement sets forth the basic terms of the purchase and sale of stock to investors. The main terms of negotiation that are involved in this agreement are the price and number of shares being sold and the representations and warranties that the company and perhaps founders make to the investors. The stock purchase agreement does not set forth the characteristics of the stock being sold or the relationship among the parties after the closing.

Many venture capital industry players often speak about differences in the "East Coast" and "West Coast" approaches to venture financing found in the stock purchase agreement. Although some cultural differences between the more bank-driven East Coast culture and entrepreneur-driven West Coast culture exist, many of the fundamental considerations are the same. One of the main differences is that northeast investors tend to want personal liability for misrepresentations of founders. Non-northeast entrepreneurs are generally less comfortable with personal liability in risky investments.

Investors' Rights Agreement

An investors' rights agreement can cover many different subjects. Frequently, it covers information rights (the right to receive or have access to financial or other information about the company and sometimes the right to attend meetings of the board of directors), registration rights, contractual preemptive rights (the right to purchase securities in subsequent equity financings conducted by the company), and various postclosing covenants.

Right of First Refusal and Cosale Agreement

A right of first refusal agreement requires a shareholder to grant the company a right to match any offers for their stock. This effectively preempts other buyers and may prevent

loss of control of the company. The right of first refusal may also include the provision that the company must buy back the shares of a shareholder who dies or leaves the company.

A variation of the right of first refusal (and often a more appealing option from the company perspective) is the right of first offer agreement. The right of first offer agreement provides that a shareholder takes a proposed price and set of terms for shares to be sold to the company, but, if the company turns down the offer, the shareholder becomes free to sell the stock to a third party, if the price is the same or greater than offered to the company.

The purpose of the cosale agreement is to provide the investors with the right to participate in sales by a founder (or other major shareholder) of the company.

Voting Agreement

A voting agreement is an agreement among shareholders to vote their shares in a certain way. In the context of a financing, this usually means holders of preferred stock agree with the major holders of common stock to vote their shares in a specified manner for the election of directors. By entering a voting agreement, the shareholders can override the standard one-share-one-vote rule and maintain management control.

Legal Opinion

In the opinion letter, a law firm renders an opinion as to the qualification of the company to enter into a venture financing deal and the legal validity of the documents used in the process. These opinions generally cover whether the company is properly formed, whether the company can enter into the venture financing deal, and whether the other legal documents used in the venture financing deal are enforceable and duly executed. The legal opinion, however, does not act as a warranty that all assets and activities of the company are legal. For instance, the opinion will not assess whether the assets and intellectual property claimed by the company is all properly owned and noninfringing.

Indemnification Agreement

Indemnification is the act of being held not liable or being protected from costs of liability by shifting them to another party. An indemnification agreement, then, simply shifts the financial liability of certain acts onto another party. Indemnification agreements can cover both corporate officers and directors. Some investors ask to be covered by an indemnification agreement as well. Investors will only be covered by indemnification when they act as an agent of the corporation. If investors seek indemnification for actions other than those under the corporate veil, indemnification provisions would need to be specified in the stock purchase agreement.

Indemnification agreements have several important purposes. On the one hand, they may provide heightened protection above that provided in a certificate of incorporation or bylaw because they cannot be amended without the approval of the indemnitee. Additionally, they can make indemnification mandatory in which default laws may otherwise make it permissive.

Some companies provide mandatory indemnification for directors and discretionary indemnification for officers. There may be situations in which mandatory indemnification of officers would make a company look bad, such as in a discrimination case. Companies should therefore use care when deciding whether to indemnify their officers.

SAMPLE DOCUMENT

Series A Preferred Stock Term Sheet

MEMORANDUM OF TERMS FOR THE PRIVATE PLACEMENT OF SERIES A PREFERRED STOCK OF HIGH- TECH STARTUP INC. (the "Company"):

Amount to be raised: \$2,000,000

Type of security: Series A Preferred Stock ("Series A Preferred")

Number of shares: 2,000,000 shares

Purchase price: \$1.00 per share (the "Purchase Price")

Investors:

	Investment amount	Number of shares
TopTech Venture LP	\$1,250,000	1,250,000
ABC Ventures LP	\$750,000	750,000
	\$2,000,000	2,000,000

Closing date: The closing of the sale of the Series A Preferred (the "Closing") will be on or before June 30, 2009.

Postfinancing capitalization:

Class	Number of shares	Percent
Common Stock	3,000,000	50.00%
Series A Preferred Stock	2,000,000	33.33%
Option pool:		
Outstanding	100,000	1.67%
Future grants	900,000	15.00%
Total	6,000,000	100%

Rights, preferences, and restrictions of preferred stock:

Dividends: The holders of Series A Preferred will be entitled to receive noncumulative dividends in preference to the holders of Common Stock at an annual rate of 8% of the Purchase Price per share from legally available funds and when, as and if declared by the Board of Directors.

Liquidation preference: In the event of any liquidation, dissolution or winding up of the Company, the holders of Series A Preferred Stock will be entitled to receive in preference to the holders of Common Stock, the amount of \$__ per share plus declared and unpaid dividends, if any. Thereafter, the remaining assets of the Company will be distributed ratably to the holders of Common Stock. A Liquidation Transaction shall be treated as though it were a liquidation, for purposes of triggering an immediate obligation to pay an amount equal to the aggregate liquidation preference of the Preferred Stock. A "Liquidation Transaction" means an Acquisition of the Company, as defined immediately below, provided that if the holders of at least ___% of the Preferred Stock elect not to treat the transaction as a Liquidation Transaction, an Acquisition of the Company shall be deemed not to constitute a Liquidation Transaction.

An "Acquisition of the Company" means (1) a sale, conveyance or other disposition of all or substantially all of the property or business of the Company, (2) a merger or consolidation with or into any other entity, unless the stockholders of the Company immediately before the transaction own 50% or more of the voting stock of the acquiring or surviving corporation following the transaction (taking into account, in the numerator, only stock of the Company held by such stockholders before the transaction and stock issued in respect of such previously held Company stock), or (3) any other transaction which results in (assuming an immediate and maximum exercise/conversion of all derivative securities issued in the transaction) the holders of the Company's capital stock as of immediately before the transaction owning less than 50% of the voting power of the Company's capital stock as of immediately after the transaction, provided, however, that an equity financing transaction in which the Company is the surviving corporation and does not (directly or through a subsidiary) receive any assets other than cash and rights to receive cash shall be deemed not to constitute an Acquisition of the Company. A series of related transactions shall be deemed to constitute a single transaction, and where such transactions involve securities issuances, they shall be deemed "related" if under applicable securities laws they would be treated as integrated.

The liquidation preference of the Preferred Stock, if not specified in a merger agreement, will be paid 100% in the form of cash unless the Board of Directors elects to pay it in another form; if the Board does so elect, all stockholder of the same class must be treated equally.

Redemption: The Series A Preferred will not be redeemable, except to the extent the liquidation provisions specified above are deemed by any applicable law to constitute redemption.

Voluntary conversion: Each holder of Series A Preferred will have the right, at the option of the holder at any time, to convert shares of Series A Preferred into shares of Common Stock at an initial conversion ratio of one-to-one.

Automatic conversion: The Series A Preferred will be automatically converted into Common Stock, at the then applicable conversion rate, in the event of either (1) the consent of the holders of a majority of the then outstanding Preferred Stock, voting together as a class, or, if earlier, (2) immediately before the closing of an underwritten initial public offering of the Company's Common Stock pursuant to a Registration Statement under the Securities Act of 1933, as amended with aggregate proceeds of at least \$__ million at a public offering price (adjusted for intervening common stock splits, reverse stock splits and stock dividends) of at least \$_____ per share (a "Qualified IPO").

Antidilution provisions: The conversion price of the Series A Preferred will be subject to proportional adjustment for stock splits, stock dividends and the like, and to adjustments on a broad-based weighted average basis for issuances at a purchase price less than the then-effective conversion price, subject to the following carve outs:

- (1) common stock issued pursuant to stock splits and common-stock-on-common-stock dividends,
- (2) up to 1,000,000 shares of common stock issued or issuable to employees, officers, consultants or directors of the Company, or

other persons performing services for the Company, directly or pursuant to a stock option plan or restricted stock plan or agreement approved by the Board of Directors;

- (3) capital stock, or options or warrants to purchase capital stock, issued to financial institutions with federal or state charters or to lessors in connection with commercial credit arrangements, equipment financings, commercial property lease transactions or similar transactions;
- (4) capital stock issued or issuable to an entity as a component of any business relationship with such entity for the purpose of (a) joint venture, technology licensing or development activities, (b) distribution, supply or manufacture of the Company's products or services or (c) any other arrangements involving corporate partners that are primarily for purposes other than raising capital, the terms of which business relationship with such entity are approved by the Board of Directors;
- (5) capital stock, or warrants or options to purchase capital stock, issued in connection with bona fide acquisitions, mergers or similar transactions, the terms of which are approved by the Board of Directors;
- (6) common stock or other underlying security actually issued upon conversion, exchange or exercise of any derivative security;
- (7) common stock issued or issuable in or under a Qualified IPO;
- (8) common stock issued or issuable as a result of the antidilution provisions of any derivative securities; and
- (9) common stock issued or issuable in or under a transaction for which the holders of at least a majority of the then outstanding shares of Preferred Stock, voting together as a class, adopt a resolution that expressly states that such Common Stock is not to be considered Additional Shares.

Voting rights: The holder of a share of Series A Preferred will be entitled to that number of votes on all matters presented to stockholders equal to the number of shares of Common Stock then issuable upon conversion of such share of Series A Preferred. Notwithstanding the foregoing, the Series A Preferred shall not be entitled to vote on any matter for which voting is expressly reserved, by law or the express provisions of the Company's Certificate of Incorporation, solely for a class or classes of stock other than the Preferred Stock, or for one or more series of Preferred Stock other than the Series A Preferred.

Protective provisions: So long as at least 1,000,000 shares of Preferred Stock remain outstanding, the Company will not (by amendment, merger, consolidation or otherwise, and either directly or indirectly by a subsidiary), without the approval of a majority of the Preferred Stock, voting together as a class.

- (1) effect (a) a liquidation, dissolution or winding up of the Company (b) an Acquisition of the Company, or (c) any other merger or

consolidation of the Company, or a subsidiary of the Company, with or into any other entity;

- (2) alter or change the rights, preferences or privileges of the Preferred Stock so as to materially and adversely affect such shares;
- (3) increase or decrease the number of authorized shares of the Preferred Stock or the Series A Preferred;
- (4) authorize the issuance of securities having a preference over or on a parity with the Series A Preferred as to dividends or liquidation;
- (5) redeem, repurchase or otherwise acquire shares of Preferred Stock or Common Stock other than in accordance with **[the redemption provisions of the Preferred Stock or]** the repurchase of shares from employees, officers, directors, consultants or other persons providing services to the Company at no greater than cost pursuant to the original terms of such agreements, or such modified terms as have been agreed to by the Board of Directors **[including the Series A director representative then in office, if any]**.

Registration rights:

Registrable Securities: All shares of Common Stock issuable upon conversion of the Preferred Stock shall be deemed "Registrable Securities."

Demand registration: Beginning December 31, 2012, or six months after a Qualified IPO, whichever is earlier, _____ demand registrations of at least \$_____ each, upon initiation by holders of ___% of the outstanding Registrable Securities.

Piggyback registration rights:

Unlimited piggyback registration rights, subject to pro rata cutback to a minimum of ___% of the offering (complete cutbacks on the IPO) at the underwriter's discretion.

Registration on Form S-3: The holders of at least ___% 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, shares of Registrable Securities for an aggregate offering price of at least **[\$500,000]**. The Company will not be obligated to effect more than two S-3 registration statement in any twelve month period.

Registration expenses: Registration expenses (exclusive of underwriting discounts and commissions, stock transfer taxes and fees of counsel to the selling stockholders) will be borne by the Company for all demand, piggyback and S-3 registrations. The Company will also pay the reasonable fees and expenses of one special counsel to the selling stockholders **[not to exceed \$_____]**.

Assignment of registration rights: The registration rights may be transferred to a transferee who acquires at least _____ shares of the original purchaser's Registrable Securities (or all of such the transferring holder's shares, if less), provided that the Company is given prompt notice of the transfer and the transferee agrees to be bound by the terms and conditions of the Investors' Rights Agreement. Transfer of registration rights to a partner or affiliate of the transferee will be without restrictions as to minimum shareholdings.

Lockup agreement: In connection with a Qualified IPO, each holder of registration rights will be required not to sell or otherwise dispose of any securities of the Company (except for those securities being registered) for a period of 180 days following the effective date of the registration statement for such offering if so requested by the underwriters of such offering subject to such extensions of time as may be required by the underwriters under NASD Rule 2711 or a successor rule.

Termination of registration rights: The registration obligations of the Company will terminate on the earlier of (1) ___ years after a Qualified IPO, (2) with respect to any holder of registration rights, at such time as all Registrable Securities of such holder may be sold within a three month period pursuant to Rule 144 or (3) upon an Acquisition of the Company.

Information rights:

So long as a holder of Series A Preferred continues to hold [at least ____] shares of Series A Preferred or Common Stock issued upon conversion of Series A Preferred, the Company will deliver to such holder annual, quarterly and monthly financial statements as well as an annual budget. The obligation of the Company to furnish such information will terminate at such time as the Company (1) consummates an IPO, (2) becomes subject to the reporting provisions of the Securities Exchange Act of 1934, as amended, or (3) upon an Acquisition of the Company.

Right of first offer:

Each holder of at least ___ shares of the Series A Preferred will have the right in the event the Company proposes to offer equity securities to any person other than:

- (1) common stock issued pursuant to stock splits and common-stock-on-common-stock dividends,
- (2) up to 1,000,000 shares of common stock issued or issuable to employees, officers, consultants or directors of the Company, or other persons performing services for the Company, directly or pursuant to a stock option plan or restricted stock plan or agreement approved by the Board of Directors;
- (3) capital stock, or options or warrants to purchase capital stock, issued to financial institutions with federal or state charters or to lessors in connection with commercial credit arrangements, equipment financings, commercial property lease transactions or similar transactions;
- (4) capital stock issued or issuable to an entity as a component of any business relationship with such entity for the purpose of (a) joint venture, technology licensing or development activities, (b) distribution, supply or manufacture of the Company's products or services or (c) any other arrangements involving corporate partners that are primarily for purposes other than raising capital, the terms of which business relationship with such entity are approved by the Board of Directors;
- (5) capital stock, or warrants or options to purchase capital stock, issued in connection with bona fide acquisitions, mergers or similar transactions, the terms of which are approved by the Board of Directors;

- (6) common stock or other underlying security actually issued upon conversion, exchange or exercise of any derivative security;
- (7) common stock issued or issuable in or under a Qualified IPO;
- (8) common stock issued or issuable as a result of the antidilution provisions of any derivative securities; and
- (9) securities which, with the unanimous approval of the Board of Directors, are not offered to any existing shareholders, to purchase that portion of such equity securities equal to (a) the number of shares of Common Stock issued or issuable upon conversion of the Series A Preferred held by each holder of Series A Preferred divided by (b) all of the Company's Common Stock then outstanding or issuable upon exercise of options or warrants or conversion (on a fully-diluted basis) of Preferred Stock. Such equity securities shall be purchased within 15 days from notice by the Company and on the same terms as they are purchased by other third party purchasers of the equity securities. Such right of first offer will terminate upon an IPO or upon the acquisition of the Company. The right of first offer shall not be applicable with respect to any covered investor and any subsequent securities issuance, if (a) at the time of such subsequent securities issuance, such investor is not an accredited investor, and (b) such subsequent securities issuance is otherwise being offered only to accredited investors.

Cosale right and right of first refusal:

Holders of Preferred Stock shall have the right to participate on a pro rata basis in transfers of stock for value by _____ and _____ (the "Founders") (with customary exceptions for transfers in connection with estate planning and similar matters and an exception for up to 5% of each Founder's common stock). This right will terminate immediately prior to the IPO or an acquisition of the Company.

The existing right of first refusal and vesting provisions with respect to the Founders' stock will remain in effect. The right of first refusal will be assigned to the holders of the Preferred Stock on a pro rata basis in the event it is not exercised by the Company.

Board of directors:

So long as _____ shares of Preferred Stock shall remain outstanding, the Preferred Stock, voting together as a class, shall be entitled to elect _____ member(s) of the Company's Board of Directors, and the remaining members will be elected by the Preferred Stock and Common Stock voting together as a class. Upon closing of the financing, the Board of Directors of the Company shall consist of _____.

Exclusivity:

In consideration of ___ investing substantial time, effort and expense in connection with the evaluation and execution of the transactions contemplated by this term sheet, the Company agrees that it will immediately cease any and all discussions or interactions with third parties concerning alternative financing transactions and, for a period of time expiring on the earlier of _____ or the date that _____ shall have notified the Company in writing that it does not intend to proceed with the transactions contemplated hereby, (a) the Company and _____ will work in good faith toward the

	consummation of the transactions contemplated by this term sheet and (b) the Company will not negotiate with, provide information to, or otherwise interact with any third party concerning any alternative transaction.
<i>Purchase agreement:</i>	The sale of the Series A Preferred will be made pursuant to a stock purchase agreement reasonably acceptable to the Company and the Investors, which agreement will contain, among other things, appropriate representations and warranties of the Company and the Investors, covenants of the Company reflecting the provisions set forth in this term sheet and appropriate conditions to closing which will include, among other things, qualification of the shares to be sold under applicable Blue Sky laws, and the filing of Amended and Restated Certificate of Incorporation.
<i>Expenses:</i>	If the Financing is consummated, the Company will pay the hourly fees and expenses of one special counsel to the Investors, not to exceed \$[_____].
<i>Counsel to the company:</i>	Cooley Godward Kronish LLP

BOARD OF DIRECTOR FIDUCIARY DUTIES IN A VENTURE FINANCING

Federal and state laws closely regulate the offer and sale of securities, which include stock, options, and warrants. On the corporate level, the board of directors must approve all offers and issuances of securities. When claims are brought for breach of fiduciary duties, however, VC directors are the most likely target. They are perceived to have the deepest pockets, both personally and as a result of supplemental directors' and officers' liability insurance maintained by their fund to cover claims at the portfolio company level.

In most jurisdictions, the directors of a company owe a fiduciary duty to both the company and its shareholders. This duty includes both a "duty of loyalty" and a "duty of care." Under the duty of loyalty, a director must act in a manner reasonably and honestly believed to be in the best interests of the company and its shareholders, seeking to avoid any conflict of interest situations. The director must place the interests of the company and its shareholders above the interests of the director or any entity that the director represents.

Directors are also required to exercise the amount of care that an ordinarily careful and prudent person would use in similar circumstances. A director's duty of care comprises care in both the decision-making process and overseeing the conduct of employees and advisors. To fulfill his duty of care in decision-making, a director must base his decisions on all material information reasonably available to him and he must critically assess that information. To fulfill his duty of care in oversight, a director must conduct adequate and necessary inquiries in which suspicions of misconduct should be, or are, aroused.

Adherence to one's fiduciary duties is critically important for a director because directors are personally liable for breaches of their duty of care. Some state laws, including Delaware, allow companies to limit or eliminate the personal financial liability of their directors for breaches of fiduciary duty. This director immunity does not apply in some circumstances, as follows: when the breach is of a duty of loyalty; when the director commits acts of omissions not in good faith or which involve intentional misconduct or a knowing violation of law; when directors make unlawful payments of dividends or unlawful stock purchases or redemptions; or when the director derives an improper personal benefit from transactions.

In addition to immunity from liability written into a corporate charter, the business judgment rule provides additional protection for directors. The rule creates a presumption that a director acted properly in his/her decision-making process. The rule also places a difficult burden of proof to rebut this presumption on a plaintiff challenging it. For the business judgment rule to apply, generally the following criteria is needed: the decision was free from a conflict of interest; the directors must have acted or made a deliberate decision not to act; the directors must have considered all material information reasonably available to them; and the directors' decision must be based on a good faith belief that it is in the best interests of the corporation.

One particular aspect of a director's fiduciary duty with respect to venture financing is worth noting. When a company is insolvent or nearing insolvency, directors owe their primary duty to creditors rather than to stockholders. Directors are responsible for preserving asset value for eventual distribution to the creditors. A debtor becomes insolvent when its liabilities exceed its assets at a fair evaluation or it lacks sufficient property to pay its existing debts as they mature. After insolvency, directors' actions are judged by a trustee standard rather than by the business judgment rule. Under the trustee standard, directors are required to exercise such care and skill as a person of ordinary prudence would exercise in dealing with his own property. Directors may be subject to personal liability for harm to creditors resulting from mere negligence under the trustee standard.

WASHOUT FINANCINGS

Washout financing refers to financing at a late stage in venture financing when a once highly valued company is now valued at a much lower price (a "down round"). Venture capitalists are faced with the choice of either bailing on their investment or investing more money to save their struggling investment. Because the risk is high with washout financing, favorable terms are often extended in exchange for an equity stake.

According to the November 2007 Private Company Financing Report by Cooley Godward Kronish LLP, 78% of financings over the 2005–2007 period were "up rounds" (deals done at a higher price than the previous fundraising round), whereas 22% were considered to be "down rounds" (deals done at a lower price than the previous fundraising round).

To avoid accusations of breach of fiduciary duty, the VC firm (through its representative on the board of the company) will need to show that it has sought financing alternatives that were more favorable to the company and the nonparticipating existing investors. VC firms that have board representation in a portfolio company must remember that their representation on the board mandates owing a duty of fairness and good faith to all shareholders (including the minority shareholders). Often, controlling shareholders also have a fiduciary duty of disclosure to the minority. In the context of the financing, the VC investor is obliged to disclose all of the terms of the financing to the minority shareholders.

In lawsuits against VC firms and shareholders, courts tend to give deference to the decisions of controlling shareholders of the company. Courts believe that controlling shareholders can act in their own interest, even if at the expense of minority shareholders, as long as there is no fraud, bad faith, or malice. For Delaware companies, there is no statutory protection for minority shareholders. To protect against washout financing, a claim of breach of fiduciary duty would need to be brought. However, the business judgment rule provides directors with a presumption of good faith.

To avoid problems resulting from a washout financing, such as suits from disgruntled shareholders, investors must offer all shareholders the investment opportunity to purchase newly issued stock. Stockholders can purchase the percentage of stock issued that they already own in the company to preserve their ownership power. Of course, this offer may not mean much to the shareholders if they do not have the financial resources to buy the offered shares. Legally, however, it may prevent against breach of fiduciary duty claims.

When founders of a startup or other initial investors have negotiated antidilution clauses, washout financings are difficult. In most investments, however, the founders do not have antidilution protection. These provisions limit a company's ability to negotiate successive rounds of financing, and many VC firms do not permit such protection for founders. Also, during initial rounds of financing, investors and founders generally do not imagine scenarios of insolvency and are less likely to fight for antidilution provisions.

2007 Top Venture Capital Firms

Venture capital firm	Location	Number of deals in 2007
Draper Fisher Jurvetson	Menlo Park, CA	100
New Enterprise Associates	Baltimore, MD	87
Intel Capital	Santa Clara, CA	70
Polaris Venture Partners	Waltham, MA	61
Kleiner Perkins Caufield & Byers	Menlo Park, CA	56
Sequoia Capital	Menlo Park, CA	55
Menlo Ventures	Menlo Park, CA	54
Canaan Partners	Westport, CT	50
U.S. Venture Partners	Menlo Park, CA	49
Accel Partners	Palo Alto, CA	48

Foundation Capital	Menlo Park, CA	48
Highland Capital Partners LLC	Lexington, MA	47
InterWest Partners	Menlo Park, CA	47
Venrock Associates	New York, NY	47
Alta Partners	San Francisco, CA	44
Bessemer Venture Partners	Larchmont, NY	44
Domain Associates LLC	Princeton, NJ	43
Atlas Venture, Ltd.	Waltham, MA	42
Mohr Davidow Ventures	Menlo Park, CA	42
Austin Ventures, L.P.	Austin, TX	40
North Bridge Venture Partners	Waltham, MA	40
Sigma Partners	Menlo Park, CA	40
Morgenthaler Ventures	Menlo Park, CA	39
Versant Ventures	Menlo Park, CA	39
Benchmark Capital	Menlo Park, CA	38
Sevin Rosen Funds	Dallas, TX	38
Advantage Capital Partners	New Orleans, LA	37
Pequot Capital Management, Inc.	Westport, CT	37
Duff Ackerman & Goodrich LLC	San Francisco, CA	36
Frazier Healthcare and Technology Ventures	Seattle, WA	36
Lightspeed Venture Partners	Menlo Park, CA	36
VantagePoint Venture Partners	San Bruno, CA	36
Khosla Ventures	Menlo Park, CA	35
ARCH Venture Partners	Chicago, IL	34
Battery Ventures LP	Waltham, MA	34
First Round Capital	West Conshohocken, PA	34
Flagship Ventures	Cambridge, MA	32
Goldman, Sachs & Co.	New York, NY	32
Mayfield Fund	Menlo Park, CA	32
Sutter Hill Ventures	Palo Alto, CA	32
General Catalyst Partners	Cambridge, MA	31
Redpoint Ventures	Menlo Park, CA	31
SV Life Sciences Advisers	Boston, MA	31
Trident Capital	Palo Alto, CA	31
Oak Investment Partners	Westport, CT	30
Prism Venture Partners	Westwood, MA	30
Village Ventures	Williamstown, MA	30
Intersouth Partners	Durham, NC	29
Velocity Interactive Group	Palo Alto, CA	29
Oxford Bioscience Partners	Boston, MA	28
Sanderling Ventures	San Mateo, CA	28
Adams Street Partners LLC	Chicago, IL	27
DCM	Menlo Park, CA	27
Greylock Partners	Waltham, MA	27
Scale Venture Partners	Foster City, CA	27

Source: PricewaterhouseCoopers/National Venture Capital Association MoneyTree Survey (<http://www.pwcmoneytree.com>)

2007 Top 60 Venture Capital Firms for Early Stage Companies		
Venture capital firm	Location	Number of deals in 2006
Maryland Technology Development Corporation	Columbia, MD	22
Draper Fisher Jurvetson	Menlo Park, CA	19
Tech Coast Angels	Laguna Hills, CA	17
New Enterprise Associates	Baltimore, MD	13
Khosla Ventures	Menlo Park, CA	12
Sequoia Capital	Menlo Park, CA	12
Village Ventures	Williamstown, MA	11
Austin Ventures	Austin, TX	10
Band of Angels	Menlo Park, CA	9
Omidyar Network	Redwood City, CA	9
Canaan Partners	Westport, CT	8
Foundation Capital	Menlo Park, CA	8
Illinois Ventures LLC	Chicago, IL	8
Intel Capital	Santa Clara, CA	8
JumpStart Inc.	Cleveland, OH	8
Mohr Davidow Ventures	Menlo Park, CA	8
Polaris Venture Partners LP	Waltham, MA	8
Atlas Venture	Waltham, MA	7
Ben Franklin Technology Partners Southeastern PA	Philadelphia, PA	7
Charles River Ventures	Waltham, MA	7
Draper Richards LP	San Francisco, CA	7
Hummer Winblad Venture Partners	San Francisco, CA	7
Venrock	New York City, NY	7
Advantage Capital Partners	New Orleans, LA	6
Bessemer Venture Partners	Larchmont, NY	6
Domain Associates LLC	Princeton, NJ	6
First Round Capital	West Conshohocken, PA	6
Kleiner Perkins Caufield & Byers	Menlo Park, CA	6
Lightspeed Venture Partners	Menlo Park, CA	6
Maryland DBED	Baltimore, MD	6
Morgenthaler Ventures	Menlo Park, CA	6
Prism Venture Partners	Westwood, MA	6
Spark Capital	Boston, MA	6
Sutter Hill Ventures	Palo Alto, CA	6
Trinity Ventures	Menlo Park, CA	6
U.S. Venture Partners	Menlo Park, CA	6
ARCH Venture Partners	Chicago, IL	5
Benchmark Capital	Menlo Park, CA	5
CMEA Ventures	San Francisco, CA	5
ComVentures	Palo Alto, CA	5
De Novo Ventures	Menlo Park, CA	5

DFJ Frontier	Santa Barbara, CA	5
Flagship Ventures	Cambridge, MA	5
General Catalyst Partners	Cambridge, MA	5
Greylock Partners	Waltham, MA	5
Highland Capital Partners LLC	Lexington, MA	5
Masthead Venture Partners	Cambridge, MA	5
Matrix Partners	Waltham, MA	5
New Jersey Technology Council	Mount Laurel, NJ	5
ONSET Ventures	Menlo Park, CA	5
Sevin Rosen Funds	Dallas, TX	5
Sigma Partners	Menlo Park, CA	5
Three Arch Partners	Portola Valley, CA	5
Versant Ventures	Menlo Park, CA	5
Accuitive Medical Ventures LLC	Duluth, GA	4
Alloy Ventures	Palo Alto, CA	4
ATA Ventures	Redwood City, CA	4
Avalon Ventures	La Jolla, CA	4
Battery Ventures LP	Waltham, MA	4
BlueRun Ventures	Menlo Park, CA	4

Source: *Entrepreneur.com* Magazine

2007 Top 30 Venture Capital Firms for Later-Stage Companies

Venture capital firm	Location	Number of deals in 2006
Tech Coast Angels	Laguna Hills, CA	7
Stonehenge Capital Company	Baton Rouge, LA	6
Edison Venture Fund	Lawrenceville, NJ	5
HIG Capital Management	Miami, FL	5
New Enterprise Associates	Baltimore, MD	5
Sequoia Capital	Menlo Park, CA	5
Benchmark Capital	Menlo Park, CA	4
Polaris Venture Partners	Waltham, MA	4
Redpoint Ventures	Menlo Park, CA	4
Safeguard Scientifics Inc.	Wayne, PA	4
Advantage Capital Partners	New Orleans, LA	3
Altos Ventures	Menlo Park, CA	3
Ascend Venture Group LLC	New York, NY	3
Capital Resource Partners	Boston, MA	3
Carlyle Group	Washington, DC	3
Core Capital Partners	Washington, DC	3
Draper Fisher Jurvetson	Menlo Park, CA	3
Expansion Capital Partners LLC	San Francisco, CA	3
Goldman Sachs & Co.	New York, NY	3
Intel Capital	Santa Clara, CA	3
Milestone Venture Partners	New York, NY	3

Oak Investment Partners	Westport, CT	3
Sierra Ventures	Menlo Park, CA	3
SV Life Sciences Advisers	Boston, MA	3
Ticonderoga Capital Inc.	Wellesley, MA	3
Trillium Group LLC	Pittsford, NY	3
Udata Partners	Reston, VA	3
Village Ventures	Williamstown, MA	3
Spring Capital	Salt Lake City, UT	3
Accel Partners	Palo Alto, CA	2

Source: Entrepreneur.com magazine.