Term Sheet for Series A Round of Financing of XCorp

By Jeffrey P. Steele

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Reservoir Place
1601 Trapelo Road, Suite 205
Waltham, MA 02451
781-622-5930

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TERM SHEET
FOR SERIES A ROUND OF FINANCING OF XCORP

Amount of Investment: $3,000,000

Investors: ABC Ventures; XYZ Capital

Type of Security: Series A Convertible Preferred Stock

Premoney Valuation: $7,000,000[1]

Capital Structure Following Series A Round:	Existing holders of Common Stock	55%
	Option Pool	15%[2]
	Holders of Series A Preferred Stock	30%
	Total	100%

Use of Proceeds: The Company shall use the proceeds from this financing for working capital purposes.

Dividends: The Company will not pay dividends on its shares of Common Stock or any other stock which is junior to the Series A Preferred Stock unless a like dividend is paid on all shares of Series A Preferred Stock on a pro rata "as converted" basis.[3]

The following annotations are by Jeffrey Steele, a partner with the law firm Morse Barnes-Brown & Pendleton P.C.: Certain of the annotations and some of the language in this model term sheet (including the veto rights) are borrowed from the NVCA model legal documents. The NVCA model legal documents are important as they represent an effort on the part of the National Venture Capital Association (the NVCA) to standardize the form of definitive documents used fro venture capital transactions involving its members. To date, the NVCA forms have achieved some measure of success as the "standard forms" used by venture capital firms and their legal counsel in preparing the definitive documents for venture capital financings. However, there are exceptions (perhaps growing) with some law firms (again) attempting to distinguish their service offering in this area by producing their own "proprietary" forms which are marketed as superior to the NVCA forms in some way(s).

1. Equals the value the new investors are placing on the enterprise prior to their investment. Usually, all of the outstanding stock of the company, together with any outstanding options and warrants or other rights to buy stock of the company and any additional shares which may be reserved under the option pool, will be included in this premoney valuation.

2. The size of the option pool that venture capital investors will look for tends to range between 15% and 30% of the capital structure of the company. This percentage is calculated including the shares of Series A Preferred Stock being sold in the financing. The actual size of the pool can depend on a number of things, including the industry that the company is in, but is primarily related to the number and types of hires that the company will need to make in the foreseeable future. Thus, a company that has a complete management team at the time of the Series A round will likely need a smaller pool than a company that has one or more top management hires to make (each of whom may cost the company a significant amount of options or stock from the pool).

3. Often, venture capital investors also ask for an "accruing" dividend of between 8% and 10% or so per annum. This dividend "accrues" and is not payable unless (i) declared by the Board, (ii) there is a liquidation event (a sale of the company is considered a liquidation event, but an IPO usually isn't), or (iii) the preferred stock is redeemed. The accruing dividend is a protective device intended to provide a minimum rate of return but is usually forfeited in the event of an IPO or otherwise upon conversion of the preferred stock to common stock. (The theory is that in such cases the return on the investment will be more than the minimum which the accruing dividend provides. Therefore, the protection is not needed and is forfeited). There are a number of varieties of accruing dividends, including those that are payable in cash and those payable in additional shares of preferred stock. Also, although a basic "accruing dividend" involves a simple interest calculation, dividends may also involve compound interest-like calculations (dividends calculated upon not only the original investment amount but also upon the amount of prior accrued but unpaid dividends). Finally, dividends may also be "cumulative" or "non-cumulative" (with the absence of designation generally meaning that the dividend is "non-cumulative"). Under Delaware law, the "cumulative" concept is important as, without it, unpaid dividends would not carry over from year to year to be paid later. Rather, any accrued dividend from a particular year would need to be paid within that year or be forfeited. Thus, if the idea is that investors are to receive some minimum annual dividend from the time of their investment to the sale of the company with payment of the aggregate amount of such dividend upon sale, such dividend would need to be "cumulative". In such event, if the dividend were not cumulative, the only dividend payable would be such as had accrued during the year of sale.

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Conversion: Each share of Series A Preferred Stock shall be convertible, at any time, at the option of the holder, into shares of Common Stock, at an initial conversion ratio of one share of Common Stock for each share of Series A Preferred Stock. Mandatory conversion of the Series A Preferred Stock upon the effectiveness of a registration statement covering a firmly and fully underwritten public offering of Common Stock of the Company by a reputable underwriter acceptable to the Investors at a price which equals or exceeds five times the purchase price per share of the Series A Preferred Stock and where the aggregate gross proceeds received by the Company exceeds $25 million (a "Qualified Public Offering").[4]

Antidilution: The terms of the Series A Preferred Stock will contain standard "weighted average" antidilution protection with respect to the issuance by the Company of equity securities at a price per share less than the applicable conversion price then in effect, subject to standard and customary exceptions.[5] The conversion rate of the Series A Preferred Stock into common stock will be adjusted appropriately to account for any stock splits, recapitalizations, mergers, combinations and asset sales, stock dividends, and similar events. Antidilution protection shall not be triggered by the issuance of up to 1,000,000 shares of Common Stock (or options therefor) issued in accordance with the Company's Stock Option Plan.

Voting Rights: On all matters submitted for stockholder approval, each share of Series A Preferred Stock shall be entitled to such number of votes as is equal to the number of shares of Common Stock into which such shares are convertible. In addition, the Company shall not, either directly or indirectly by amendment, merger, consolidation or otherwise[6], without the prior consent of the holders of at least a majority of the then issued and outstanding Series A Preferred Stock, voting as a separate class:

a) liquidate, dissolve or wind-up the business and affairs of the Corporation, effect any Deemed Liquidation Event, or consent to any of the foregoing;

b) amend, alter or repeal any provision of the Certificate of Incorporation or Bylaws of the Corporation in a manner that adversely affects the powers, preferences or rights of the Series A Preferred Stock[7];

c) create, or authorize the creation of, or issue or obligate itself to issue shares of, any additional class or series of capital stock unless the same ranks junior to the Series A Preferred Stock with respect to the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends and rights of redemption, or increase the authorized number of shares of Series A Preferred Stock

4. Preferred stock should convert into common stock automatically at the company's IPO. The special rights generally accorded to preferred stock sold to early-stage investors could create problems for a public company.

5. These provisions are designed to protect an investor against "equity" dilution (later sales of stock at a price lower than what the investor paid). Although the "weighted average" version is the most common, an alternative is "full ratchet" antidilution protection. Full-ratchet antidilution protection is far more advantageous to the investor (but punitive to the company) than weighted average, but it is usually reserved for very early-stage deals or other situations where there is significant concern as to whether the valuation will hold up over the long term. Put simply, weighted-average antidilution protection accounts more accurately for the actual dilutive effect which a particular issuance has on the investor's equity position in the company. Full-ratchet antidilution protection, on the other hand, treats all later stock issuances below the investor's purchase price as if they were the same, regardless of the number of shares issued.

6. The "either directly or indirectly" language is important and is included as a result of a Delaware case involving the venture firm Benchmark Capital and one of its portfolio companies Juniper Financial Corp. Although Benchmark had the benefit of a veto right over any charter amendment "adversely affecting" Benchmark's series of preferred stock, Juniper took advantage of the opportunity to accomplish the effect of a charter amendment by means of a parent-subsidiary merger, end-running Benchmark's veto right. Litigation ensued with a result not sympathetic to Benchmark. The court took a very literal view of the language of the veto rights and pointed out that Benchmark and its counsel could have been more vigilant in preventing any such end run. Since this decision, this language has been a staple in any sophisticated venture capital documentation dealing with veto rights.

7. Under Delaware law, the authorization of another series of Preferred Stock with rights senior to those of the Series A Preferred Stock as to dividends, liquidation and redemption would generally not constitute an amendment that adversely affects the Series A Preferred Stock.

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or increase the authorized number of shares of any additional class or series of capital stock unless the same ranks junior to the Series A Preferred Stock with respect to the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends and rights of redemption;

d) (i) reclassify, alter or amend any existing security of the Corporation that is pari passu with the Series A Preferred Stock in respect of the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends or rights of redemption, if such reclassification, alteration or amendment would render such other security senior to the Series A Preferred Stock in respect of any such right, preference or privilege, or (ii) reclassify, alter or amend any existing security of the Corporation that is junior to the Series A Preferred Stock in respect of the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends or rights of redemption, if such reclassification, alteration or amendment would render such other security senior to or pari passu with the Series A Preferred Stock in respect of any such right, preference or privilege;

e) purchase or redeem (or permit any subsidiary to purchase or redeem) or pay or declare any dividend or make any distribution on, any shares of capital stock of the Corporation other than (i) redemptions of or dividends or distributions on the Series A Preferred Stock as expressly authorized herein, (ii) dividends or other distributions payable on the Common Stock solely in the form of additional shares of Common Stock and (iii) repurchases of stock from former employees, officers, directors, consultants or other persons who performed services for the Corporation or any subsidiary in connection with the cessation of such employment or service at the lower of the original purchase price or the then-current fair market value thereof [or (iv) as approved by the Board of Directors, including the approval of at least one Series A Director][8];

f) create, or authorize the creation of, or issue, or authorize the issuance of any debt security, or permit any subsidiary to take any such action with respect to any debt security [, if the aggregate indebtedness of the Corporation and its subsidiaries for borrowed money following such action would exceed $_____] [other than equipment leases or bank lines of credit] [unless such debt security has received the prior approval of the Board of Directors, including the approval of [at least one] Series A Director];

g) create, or hold capital stock in, any subsidiary that is not wholly owned (either directly or through one or more other subsidiaries) by the Corporation, or sell, transfer or otherwise dispose of any capital stock of any direct or indirect subsidiary of the Corporation, or permit any direct or indirect subsidiary to sell, lease, transfer, exclusively license or otherwise dispose (in a single transaction or series of related transactions) of all or substantially all of the assets of such subsidiary; or

h) increase or decrease the authorized number of directors constituting the Board of Directors.

Liquidation Preference: The holders of Series A Preferred Stock shall have preference upon liquidation over all holders of Common Stock and over the holders of any other class or series of stock that is junior to the Series A Preferred Stock for an amount equal to the greater of (i) amount paid for such Series A Preferred Stock plus any declared or accrued but unpaid dividends, and (ii) the amount which such holder would have received if such holder's shares of Series A Preferred Stock were converted to Common Stock immediately prior to

8. The requirement that board approval include approval by a Series A Director is a compromise between requiring approval of the holders of Series A Preferred Stock and just requiring board approval. The primary difference here is that board level approval of the Series A Director (as opposed to stockholder approval by the holders of Series A Preferred Stock) will be in such director's capacity as a member of the board of directors and therefore subject to such director's fiduciary duties to the Corporation.

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such liquidation. Thereafter, the holders of Common Stock will be entitled to receive the remaining assets. For purposes of this section, a merger, consolidation, sale of all or substantially all of the Company's assets, or other corporate reorganization shall constitute a liquidation, unless the holders of at least a majority of the Series A Preferred Stock vote otherwise.[9]

Board of Directors: The Board of Directors of the Company shall be comprised of five members. Of these five members, the holders of the Series A Preferred Stock shall have the right to designate two directors (one of such two directors to be designated by ABC Ventures, the other by XYZ Capital), and the founders of the Company shall have the right to designate two directors. The remaining director shall be designated by such four directors.[10]

Options and Vesting: All stock and options held by founders, management, and employees shall vest over a four-year period. Stock currently held by founders will be considered to be 25% vested as of the closing of this financing with the balance to vest in equal monthly installments over four years. All others shall vest in equal monthly installments over four years with a one-year cliff at the beginning of the vesting term. Change of control provisions to provide for no more than an additional 50% for founders and select management and one year for all others.[11]

Registration Rights: Commencing on the earlier of three years from the closing or six months after the effective date of the Company's first public offering, holders of shares of Series A Preferred Stock or shares of Common Stock issued upon conversion thereof ("Registrable Stock") shall have the right to demand two "S-1" registrations with aggregate gross offering price in excess of $10,000,000, upon customary terms and conditions.

The holders of Series A Preferred Stock will also be entitled to "piggyback" registration rights on Company registrations.

The holders of Series A Preferred Stock will also be entitled to unlimited registrations on Form S-3 with at least $1,000,000 in aggregate gross offering price, on customary terms and conditions.

The Company will bear all expenses related to all registrations and underwritings.

Affirmative Covenants: While any Series A Preferred Stock is outstanding, the company will:

a) maintain adequate property and business insurance.

9.This is a so-called "straight" liquidation preference. An alternative is the "double dip" or "participating" liquidation preference, which provides that the preferred stock get an amount equal to its money back (plus any accrued dividends if there is an accruing dividend) and then participates with common stock on an "as converted basis." A double-dip liquidation preference is a pricing term most often seen in early-stage deals or in "down rounds."

10 Working out what the Board will look like following the Series A round will be one of the most important matters to deal with. Generally, the Series A investors will ask for and receive representation on the board. The questions will be how many seats do they get and what effect will that have on the founders' and management's board representation. In the end, everybody involved will need to participate in, and be satisfied with, the decisions regarding board structure.

11 Venture capital investors will likely impose a vesting schedule on stock and options held by founders, management, and employees as a condition to investment. If shares or options are not yet vested, they are subject to being lost if the person ceases to work for the company for any reason. Venture capital investors impose such vesting requirements in order to provide the company's people with a reason to stay with the company. Also, if a person ceases to work for the company for any reason, the nonvested shares are available for grant to his or her replacement. The theory here is, of course, that the best business plan is worth nothing without the people to execute it.

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b) comply with all laws, rules, and regulations.

c) preserve, protect, and maintain its corporate existence; its rights, franchises, and privileges; and all properties necessary or useful to the proper conduct of its business.

d) submit all reports required under Section 1202(d)(1)(C) of the Internal Revenue Code and the regulations promulgated thereunder.

e) cause all key employees to execute and deliver noncompetition, nonsolicitation, nonhire, nondisclosure, and assignment of inventions agreements for a term of their employment with the Company plus one year in a form reasonably acceptable to the Board of Directors.

f) not enter into related party transactions without the consent of a majority of disinterested directors.

g) reimburse all reasonable out-of-pocket travel-related expenses of the Series A Preferred Stock directors.[12]

Financial Statements and Reporting: The Company will provide all information and materials, including, without limitation, all internal management documents, reports of operations, reports of adverse developments, copies of any management letters, communications with shareholders or directors, and press releases and registration statements, as well as access to all senior managers as requested by holders of Series A Preferred Stock. In addition, the Company will provide the holders of Series A Preferred Stock with unaudited monthly and quarterly and audited yearly financial statements, as well as an annual budget.

Redemption: Commencing with the date that is five years from the date of closing and on each one-year anniversary of such date thereafter, holders of at least a majority of the then issued and outstanding shares of Series A Preferred Stock may request the Company to redeem their shares at a price equal to the original purchase price for such shares plus any declared but unpaid dividends, with 1/3 of the shares to be redeemed shall be redeemed within sixty days of such redemption date, an additional 1/3 on the date that is one year from such date, and the remaining 1/3 on the date that is two years from such date.[13]

Right of First Refusal: Holders of Series A Preferred Stock shall have a pro rata right, based on their percentage of fully diluted equity interest in the company, with an undersubscription right up to the total number of shares being offered, to participate in subsequent stock issuances.[14]

12 This list includes items frequently looked for by venture capital firms, but is not exhaustive. A particular financing may have more or less or simply different covenants.

13 This is simply a right to achieve liquidity in the event that the company does not otherwise reach a sale or IPO by the end of the selected time period. Since the company cannot redeem stock if to do so would render the company insolvent, this right is useful only in situations in which the company has become some sort of a sideways play. Usually the redemption price is the price paid for the stock plus the accruing dividend, if there is one. Occasionally, venture capital firms will request that the redemption price be at the greater of such price and the then fair market value of the stock. The only thing to watch out for here is to make sure that the company can pay the redemption out over time. (In my experience, three payments over two years are common.)

14 While this is generally asked for and received by venture capital investors (who can give you a yes or no quickly without the need for elaborate disclosure documents to comply with the securities laws), a company should, in my opinion, think about resisting this request if it comes from individual investors.

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Right of First Refusal and Cosale: In the event that any of the Founders and existing executive management propose to sell their stock to third parties, the Company shall have the first right to purchase the securities on substantially the same terms as the proposed sale; the Series A Preferred Stockholders shall next have said right according to respective percentage ownership of Series A Preferred Stock or to sell proportionate percentage pursuant to cosale rights. Such rights shall terminate upon a Qualified Public Offering.

Other Provisions: The purchase agreement shall include standard and customary representations and warranties of the Company, and the other agreements prepared to implement this financing shall contain other standard and customary provisions. Definitive agreements will be drafted by counsel to the Investors. This term sheet is intended by the parties to be nonbinding.[15]

Expenses: The Company will reimburse the holders of Series A Preferred Stock for reasonable legal fees in connection with the transaction, payable at closing and only in the event that the transactions contemplated by this term sheet are consummated, up to a limit of $20,000.[16]

Conditions to Closing: Closing shall be subject to the standard and customary conditions, including the completion of due diligence and the delivery to the investors of a legal opinion of counsel to the Company, regarding standard and customary matters and satisfactory to the Investors and their legal counsel.[17]

By:________________________________ By:________________________________

15 The term sheet should be nonbinding (with the exception only of the exclusivity provision, if there is one, and any provisions regarding confidentiality).

16 The amount of expenses included in this provision depends on where the lawyers are from. Make sure that there is a cap. You may also want to resist any request to pay ongoing fees for the cost of complying with requests for waivers, etc., after the closing (except to the extent to which the investors incur fees because the company breaches its obligations to them).

17 Be on the lookout for any exclusivity provisions in this clause. Usually, such exclusivity provisions require the company to refrain from taking an investment from anyone else for a set period of time after the term sheet is signed. While an exclusivity provision may be acceptable (and is often imposed), be sure to pay attention to the time period. It should be no longer than is necessary to complete the transaction, with a little extra time for possible delays. In my opinion, 30 days should be acceptable in most instances; 60 days is pushing it in most instances; and 90 days is probably unreasonable in almost all cases. Also, make sure that the exclusivity period automatically ends in the event that the deal is called off before the period expires.

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