Entrepreneur's Guide

Venture Capital Negotiations

WOMBLE CARLYLE
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AN ENTREPRENEUR'S GUIDE TO VENTURE CAPITAL NEGOTIATIONS

This Guide is offered by Womble Carlyle Sandridge & Rice, PLLC to entrepreneurs in technology businesses as an overview of major issues typically encountered in negotiating venture capital investments. While this Guide is not a comprehensive analysis of all of the issues that can arise in structuring a venture capital investment, we believe that an entrepreneur familiar with the concepts discussed in the Guide will be a more comfortable and capable venture capital negotiator, as well as a more informed consumer of professional services.

Entrepreneurial activity has emerged as one of the leading forces driving today's information and service economy. The explosion of the Internet as a key channel for business has fueled the creation of "dot com" companies throughout our region to pursue e-commerce opportunities and these ventures, together with traditional technology companies in the software, communications, bioscience and semiconductor sectors, have helped create a robust economy and have pushed U. S. stock markets to record levels. The quality of the entrepreneurs, universities and research institutions in the Southeast and mid-Atlantic has attracted an increasing number of individual investors and venture capitalists to the region, which is rapidly emerging as one of the nation's premier generators of new and successful technology, information and life science companies. With some 400 attorneys in offices in Atlanta; Greenville, SC; Charlotte; Winston-Salem; Research Triangle Park; Raleigh; and Washington, DC, Womble Carlyle is committed to serving the needs of startup and emerging businesses and individual and institutional investors and to continuing its participation in the development and success of the region's new economy.

We hope you find this Guide interesting and informative. Happy venturing!

PLEASE NOTE: *The information in this Guide represents a general discussion of business issues relating to venture capital investments. It should not be construed as legal advice, nor should it be considered a comprehensive treatment of the issues discussed. Readers with legal questions should consult with a licensed lawyer.*

INTRODUCTION

Entrepreneurs in "start up" and other development stage high-growth businesses often seek outside investors to finance initial research, development and marketing efforts. Venture capitalists specialize in providing financing to emerging businesses in high-growth markets and industries and are an important source of financing for these entrepreneurs. The major sources of venture capital are private venture capital firms, corporate venture programs and venture capital subsidiaries of banks and other large financial institutions, any of which may take the form of a small business investment company (SBIC) licensed by the U.S. Small Business Administration. Each venture firm typically has a defined investment orientation that may be limited by geography, industry preference, amount of investment and stage of investment. Some firms specialize in "seed" or early stage investments, while others pursue expansion financing or buyout transactions. Generally, venture capitalists are active, not passive, investors. They attempt to add value to their portfolio companies by lending assistance in all aspects of business development and growth.

The structuring of each venture investment is, of course, the subject of negotiation between the venture capitalist and the entrepreneur or "founder" of the business. Such negotiations are often complicated by the differing levels of familiarity with the venture negotiations process. After all, an experienced venture capitalist typically will participate in more financing negotiations in a single year than most experienced entrepreneurs will participate in over the course of a lifetime. This Guide is intended to introduce entrepreneurs to some of the important issues that come up in most venture capital negotiations.

THE PLAYING FIELD

Once a venture capitalist makes a preliminary decision to invest in an emerging business, the parties must negotiate the terms of the investment. These terms are customarily set forth first in a Term Sheet, a nonbinding document that outlines the nature of the investment and the preliminary understanding of the parties regarding the key investment terms. The Term Sheet also provides a roadmap for drafting the legal documents that will govern the actual investment and relationship of the parties. The following issues are among the most critical issues negotiated in venture capital investments:

Valuation of the Business Opportunity

Venture capitalists often refer to the "pre-money" and "post-money" valuation of a business. ***Pre-money valuation*** is the value the parties agree to place on the entire enterprise prior to the investment of the venture capitalist. ***Post-money valuation*** is equal to the pre-money valuation of the business plus the amount of the venture capitalist's investment in the company. Because the negotiations are often conducted with reference to what percentage of the company's equity the investor will receive for its investment, it may be easier to work from post-money valuation to pre-money valuation. For example, if an investor receives 1/3 of the company's equity for a $1 million investment, the post-money valuation is $3 million (3 x $1 million) and the pre-money valuation is $2 million (the $3 million post-money valuation minus the $1 million investment).

To determine the value of the emerging business, venture capitalists will conduct an in-depth financial analysis. This will include a thorough review of the company's past operating history (if any) and its future projections as disclosed in the company's business plan. For many early stage businesses, financial projections are so uncertain that current conditions in the venture market may be the most important single factor in determining valuation. For example, if most start-up businesses in the software industry are receiving first round pre-money valuations of approximately $2 million at a given time, the negotiation for a particular investment may focus not on the precise financial forecast for the particular business, but on what distinguishes that particular business from the "typical" software start-up. Key distinguishing factors include experience and depth of the management team, state and proprietary nature of the technology, competitive environment and similar factors.

Another critical part of the analysis will be the likely need for, and size of, future rounds of financing that may be required before the venture capitalist is able to "cash out" its investment. Because such future financings will dilute the prior investors, the greater the expected need for future financing the more important it is for the venture capitalist to maximize its initial ownership interest.

Once valuation is established, the price per share can be calculated. Continuing with the above example, if the company has 500,000 shares of common stock outstanding prior to the investment, the venture capitalist will pay $4 per common stock equivalent share and receive 250,000 shares for its $1 million investment. Because equity ownership that is assigned to or included in the pre-money valuation does not dilute the equity interest received by the venture capitalist, one point of negotiation that should be addressed by companies is whether rights to acquire stock that exist or are created at the time of investment, including shares reserved for employee stock options or shares issuable upon exercise of warrants, are to be considered outstanding before the investment (in which case dilution is borne solely by the founders) or after the investment (in which case dilution is borne ratably by the founders and the venture capital investors).

At times, valuation negotiations may reach an impasse. In order to bridge a gap between the entrepreneur and investor, performance-based adjustment mechanisms may be employed. These mechanisms, which adjust the number of shares received by the investor (through the use of warrants, conversion price adjustments or other means), operate only when the company achieves (or fails to achieve) a preset financial or business milestone. The practical effect of these devices is often to shift investment risk from the venture capitalist to the entrepreneur.

Investment Vehicle

A venture capital investment in an emerging business may take two traditional forms: debt and equity. Venture capitalists generally prefer some form of equity, usually convertible preferred stock. Convertible preferred stock provides the venture capitalist with both a preference in dividend payments and, of greater importance, a liquidation preference. Preferred stock may also provide an alternative exit route through the application of redemption provisions. These preferences assure that the investors who put up cash will have first call on that cash if the business does not succeed. At the same time, the ability to convert the preferred stock to common stock gives the venture capitalist the ability to participate in the "upside" if the business succeeds. From the emerging business's point of view, preferred stock is equity, which increases the non-debt capitalization of the firm and provides an equity cushion in the event of an economic downturn. In addition, preferred stock is usually structured so that dividend payments are accumulated and deferred, which limits the drain on cash resources that interest payments can cause. Finally, the preferences of the preferred stock typically result in a current per share value for the preferred stock substantially greater than the per share value of the common stock—the "sweat equity"—held by the business's founders and employees. This provides tax advantages in structuring equity incentives for future employees.

Anti-Dilution Protection

Venture capitalists usually insist on "anti-dilution protection" to prevent excessive dilution of their position in the event the business issues stock in the future at a lower price than that paid by the venture capitalists. This protection operates by lowering the "conversion price" at which the preferred stock can be converted into common stock. Typically, the initial conversion price is equal to the price paid for the preferred stock so that one share of preferred stock can be converted into one share of common stock. Standard anti-dilution terms mandate a proportionate reduction in the conversion price in the event of any stock split or other organic change, and are not controversial. "Price protection" anti-dilution terms typically reduce the conversion price in the event of a subsequent issuance of common stock, or preferred stock convertible into common stock, at a price below the then-existing conversion price of the preferred stock. These terms typically fall into two categories: "full ratchet" or "weighted average." In the case of a ***full ratchet***, the conversion price "ratchets" down to the lowest price paid for stock without regard to the number of shares issued. In the case of a ***weighted average*** adjustment, a formula is employed to adjust the conversion price based on the actual economic dilution occurring in the transaction. Price protection terms tend to be more controversial and thus more intensely negotiated. Entrepreneurs may be able to negotiate a provision that requires the venture capitalist to invest in a subsequent financing in order to take advantage of a downward adjustment in the conversion price. These terms are often called ***"pay-to-play"*** provisions.

Representation on Board of Directors

Venture capitalists almost always want to appoint at least one member of the Board of Directors of the emerging business and may, depending on the size of their investment, seek a majority of the seats on the Board. Sometimes, an independent Director acceptable to both the entrepreneurs and the investors will fill a "swing" seat on the Board. Rights to elect Directors can be built into the terms of the preferred stock or may be the subject of voting agreements between the entrepreneurs and the venture capitalists. The issue of Board representation is sensitive for both parties and often misunderstood. While entrepreneurs should be careful with respect to how much input and control venture capitalists will have in the management of the business through the Board and any special voting or veto rights of the preferred stock, some input is inevitable and the investor's designated Directors may provide the company with valuable functional experience or managerial experience not otherwise available.

Experienced Managers

Venture capitalists often demand that the emerging business recruit additional managers who have specialized expertise in one or more of the following areas: finance, marketing, sales, administration, and manufacturing. While this strengthens the company's management team, consideration must be given to the general issue of how these individuals will be compensated and to the specific issue of the amount and structure of any equity compensation that will be offered to them. The need for additional management expertise is obviously a sensitive issue for entrepreneurs who fear surrendering too much control of their business. From a negotiating perspective, entrepreneurs who can convince investors during the courtship period that they appreciate that additional management resources will be needed as the company grows are better positioned to delay investors from forcing a premature expansion of the management team, which can not only disrupt the business, but also dilute investors and entrepreneurs alike.

Proprietary Property

Emerging businesses are often based on some new technology, invention, application or knowledge—the frequently-talked-about "competitive advantage" or "sustainable proprietary advantage." Because this new technology, invention, application or knowledge is the basis of the firm's value, it must be protected. Protection is in the best interest of both the emerging business and the venture capitalist. The venture capitalist will demand assurances that the emerging business is taking all possible steps to protect its proprietary rights. From a due diligence perspective, venture capitalists may require patentability and noninfringement opinions covering a company's key technologies. Venture capitalists also typically require the company to obtain from all its employees agreements that assign to the company all rights to proprietary inventions made during their employment. Finally, venture investors place enormous importance on assuring that the technology belongs to the business itself and cannot be taken back by the entrepreneur or others in the future.

Founder Employment Agreements

Often, emerging businesses depend heavily on one or more key employees, usually founders, whose loss would be detrimental to the company. Venture capitalists often require employment agreements with these key employees to create a more stable and structured environment for both the employee and the company. Employment agreements often cover the following issues: (1) term of employment; (2) duties and responsibilities of the employee; (3) compensation of the employee; (4) benefits of the employee, including bonuses, equity incentives, health, life, and disability insurance, vacation and other programs; (5) the means and consequences of termination of employment; (6) the terms of any severance to be paid upon termination; (7) protection of trade secrets and inventions provisions; (8) post-employment noncompetition and nonsolicitation requirements; and (9) restrictions on stock owned by the employee. Negotiation of the terms of employment is critical for founders and other key employees.

Employee Equity Incentives

Many emerging businesses offer current and future employees an opportunity to purchase company stock by establishing stock option plans. These plans typically provide for the grant of restricted stock and stock options (both incentive and nonqualified) and usually include ***"vesting"*** provisions that require the employee to remain in the employment of the business for a number of years (typically three to five) to "earn" all of the equity—thus the term "sweat equity." Founders and others who already own shares and who have made a substantial "sweat" investment prior to the financing should negotiate for up-front vesting, although venture investors, who are usually investing largely because they believe the founders are uniquely suited to executing the business plan, will very frequently insist on subjecting at least some significant portion of the founder equity to vesting. Treatment of the entrepreneur's vested and nonvested shares upon termination of employment is of critical importance. Depending on the reason for termination, shares may be forfeited, subject to repurchase by the company or otherwise affected.

Stock option plans serve three functions. First, employees will have a greater incentive to make the emerging business more profitable if they own stock in the company. Second, the vesting arrangement has the effect of encouraging the employee to remain with the company for a substantial period of time. Third, savvy prospective employees have come to expect options as a means for greater award if a company succeeds, and they are often willing to receive less salary if they are granted options.

In calculating the valuation of the business, and the relative ownership shares of the founders and investors, entrepreneurs should remember the need to set aside a reasonable number of shares for future issuance to employees. A figure between ten and twenty percent is not uncommon, depending on such factors as the number and level of managers and other employees likely to be brought on board, and the amount of time and risk associated with executing the business plan.

Registration Rights

Venture capitalists may realize a profit on their investment in an emerging business in either of two ways. The first is a sale of their preferred stock to another investor (including to another company acquiring the business in a merger or similar transaction). Sales to investors other than in a merger or similar transaction are often complicated and expensive. The second way the venture capitalist may realize a profit is to convert its preferred shares into common shares and sell the common shares. This usually occurs after the company or its founding shareholders decide to sell shares to the public in an initial public offering (IPO). ***"Piggyback" registration rights*** give the venture capitalists the right to register certain of their common shares for sale with state and federal authorities when the company or founding shareholders decide to register their own common shares. ***"Demand" registration rights*** give the venture capitalists the right to force a company to register their shares at the request of the venture capitalists. While forced registrations of venturebacked companies are rare, venture capitalists have traditionally placed considerable importance on obtaining at least one, and sometimes two or more, "demand rights." Founders should seek their own "piggyback rights," but are seldom granted "demand rights" of their own.

Co-Sale Rights

Co-sale rights allow the venture capitalist to participate in a sale of common stock by designated major shareholders by selling shares along side the shareholder on a proportional basis. These rights prevent founders and other key shareholders from cashing out their investment in the business and leaving the venture investors holding the bag. Further, it is often the case that an outside party, either an investor or a competitor, is willing to pay a premium price for shares of common stock if the party can attain a controlling interest in the company. If the venture capitalists were not given the right to participate in such a sale, they would be foreclosed from receiving a portion of this premium and could find themselves in the position as a minority shareholder in a non-public business without any viable route to liquidity.

Redemption

Most venture capitalists prefer to terminate their investments in emerging businesses within a reasonable time period, usually less than seven years. To this end, a venture capitalist may request a redemption provision that requires the company to redeem the venture capitalist's securities on or after some pre-determined date at cost or at cost plus a defined premium (usually much lower than the initially hoped for cash-out value). Alternatively, the company may request a provision that gives the company the right to redeem the securities on or after some date. Such a provision gives the company more control over its capital structure as the company matures. Entrepreneurs should negotiate redemption rights with great care, as premature redemption rights—that is, redemption rights that are triggered before the business has become capable of financing its development from internal sources—can wreak havoc on future financing and growth plans. A venture investor's request for redemption rights can sometimes be wholly or partially resisted by a request for similar company redemption rights.

THE TERM SHEET

The Term Sheet provides a summary of the key terms of the proposed financing. The Term Sheet may be more or less detailed, as the parties desire. A more detailed term sheet reduces the risk of costly "surprises" as the deal moves from Term Sheet stage to closing—surprises that may require substantial renegotiation and increase legal and other costs. Occasionally, however, the entrepreneur may find it advantageous to "set the hook" with a less detailed Term Sheet with the expectation that the momentum associated with reaching agreement on terms is more likely to drive the transaction to closing. The parties are usually best served by hashing out as many of the important issues as possible at the Term Sheet stage.

We have included in this Guide a sample Term Sheet for a first round of venture investment.

SUMMARY OF PROPOSED TERMS OF INVESTMENT SERIES A CONVERTIBLE PREFERRED STOCK

__________________, 200__

Issuer:	Newco, Inc. ("Company").
Current Outstanding Securities:	1,500,000 shares of fully diluted Common Stock equivalents.[1]
Investors:	Venture Funds A & B ("Investors").
Amount of Investment:	$1,000,000 for 1,000,000 shares of Series A Convertible Preferred Stock, $0.01 par value ("Series A").
Price Per Share:	$1.00.
Minimum Purchase[2]:	250,000 shares ($250,000).
Minimum to Close[3]:	$750,000. One or more delayed closings may be held to complete the sale of all of the Series A.[4]
Closing:	Currently, closing is estimated to occur on or before _________________, 200___.

[1] To determine the "fully diluted" shares, count shares actually issued and add shares subject to outstanding options, warrants and the like and shares reserved for issuance to specific groups in the future (such as future employees under an option plan).

[2] The minimum amount any single investor can purchase.

[3] This assures each investor that the business will receive at least an agreed minimum of financing at the closing.

[4] Often a time limit is established for subsequent closings (30-120 days is common).

Conditions of Closing:

Any investment is subject to the following conditions:

- the satisfactory completion of customary due diligence;
- the satisfactory review by the Investors of all relevant documents;
- negotiation and execution of a definitive preferred stock purchase agreement and related documents; and
- other conditions of closing customary for transactions of this nature. [5]

Description of Series A:

(1) *Dividend Provisions:*

The holders of Series A will receive an 8% noncumulative dividend when, as and if declared by the Board of Directors. No dividends will be paid on shares of Common Stock during any year until an 8% dividend has been paid on the Series A and no dividend in excess of $0.08 will be paid on shares of Common Stock. [6]

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[5] It must not be forgotten that while a Term Sheet is a serious expression of interest by the parties, it is *not* a contract, and usually does not bind either party, although in some cases, investors may seek a binding agreement with a company to deal exclusively with the investors during a limited time period.

[6] Dividend rates are not intended to reflect the risk associated with the investment; they tend to be set at or below 10%. With a noncumulative dividend feature, the holders of the Series A will receive dividends only if the Board of Directors determines that it is in the best interests of the company to pay such dividends. Because the company will most likely need its cash resources to develop and market its technology, it is highly unlikely that the company will pay dividends until it becomes a public company (if ever). Conversely, cumulative dividends automatically accrue over time even if the company does not declare or pay dividends. If cumulative dividends are not paid prior to liquidation, the liquidation preference of the preferred stock is increased by an amount equal to the accrued, but unpaid dividends. Treatment of accrued dividends also needs to be considered upon conversion of the Series A.

(2) *Liquidation Preference*:

In the event of the liquidation, dissolution or winding up of the Company, the holders of Series A will be entitled to receive in preference to the holders of Common Stock an amount equal to $1.00 per share, plus any declared but unpaid dividends ("Liquidation Amount").

After payment of the above preference, holders of Series A will share with holders of Common Stock all remaining proceeds available for distribution to shareholders on an "as converted to common" basis.[7] At the option of the holders of the Series A, a sale or merger of the Company will be deemed a liquidation.[8]

(3) *Redemption*:

Commencing three years after closing (mandatory redemption date), at the request of the holders of at least 600,000 shares of Series A, the Company will redeem all (but not less than all) the Series A held by such holders by paying in cash

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[7] So-called "participating" preferred stock grants its holders not only a preference over the common stock equal to the original purchase price of the preferred stock plus accrued dividends, but also a right to share with the common shareholders assets that remain after payment of the preference. Entrepreneurs are wise to try to limit or eliminate this provision, but can expect resistance from some venture investors. Potential limitations include providing for a "slice" of proceeds to be paid to the common holders after the payment of the initial preferred preference, capping the participation right or eliminating the participation right to the extent the proceeds available on liquidation exceed or are less than a stated threshold.

[8] This very common provision highlights the potential cost to entrepreneurs of issuing participating preferred stock; upon a merger or sale of the company, preferred holders are assured of a return of their capital, plus accrued dividends, plus a proportional share of any remaining sale proceeds. If possible, the provision should be limited so that it is exercisable only by a majority (or greater percentage) of preferred holders, rather than by each individual holder.

the Liquidation Amount for the shares to be redeemed.[9] All other holders of Series A will be notified and provided with the same opportunity for redemption. If at any time the Company has insufficient funds legally available to fully discharge its redemption obligations, funds that become available thereafter will be applied to redeem the Series A until such obligations are fully discharged.

(4) Conversion:

A holder of Series A will have the right to convert the Series A, at the option of the holder, at any time, into shares of Common Stock. The number of shares of Common Stock into which each share of Series A may be converted initially will be determined by dividing $1.00 (initial price) by the conversion price. The initial conversion price of the Series A is $1.00 (conversion price). The conversion price of the Series A will be subject to adjustment for price dilution on a weighted average basis[10] and

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[9] It is common to provide for redemption to take place over two or more years, which can ease the burden on the company. It may also be possible to provide for other limitations on redemption, including minimum revenue or EBIT targets or an ability to waive redemption upon consent of the holders of a majority of the Series A.

[10] A "weighted average" or "formula" price protection clause works as follows:

$$NCP = \frac{X + Y}{X + Z} \times (OCP)$$

NCP = New Conversion Price
OCP = Old Conversion Price
Z = Shares actually issued in dilutive financing
Y = Shares that could have been issued in the dilutive financing <u>if</u> the price per share were equal to OCP
X = Shares outstanding before dilutive financing

Alternatively, investors may require a so-called "ratchet" provision where the new conversion price is equal to the price in the dilutive financing itself without regard to the size of the financing. This is an onerous provision that should, and most often can, be resisted.

will also be subject to standard adjustments for stock splits, recapitalizations and similar events. Issuance of up to 250,000 shares of Common Stock to employees pursuant to equity incentive plans approved by the Board will not be considered dilutive.[11]

(5) Automatic Conversion:

The outstanding Series A will be automatically converted into Common Stock on the closing of an underwritten public offering of shares of common stock at a public offering price per share of at least $4.00 with aggregate proceeds of at least $10,000,000 and a post-offering market capitalization of at least $25,000,000 (a "Qualified Public Offering").[12] Such conversion will be at the applicable conversion price in effect on the day next preceding the closing of the Qualified Public Offering.

(6) Registration Rights:

The holders of the Series A will be entitled to two demand registrations at the expense of the Company and unlimited piggyback registration rights; provided, however, that no demand may be made prior to the second anniversary of the closing; and,

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[11] This prevents the shares reserved for issuance to employees under the stock option plans discussed earlier from triggering anti-dilution protection. Other existing low-cost warrants also need to be excluded.

[12] This establishes offering thresholds that are high enough to give venture investors some assurance that their investment has been successful and that the post-offering market will have sufficient float to accommodate sales by the investors in the aftermarket. If an IPO does not meet the "Qualified Public Offering" definition, the venture investors would have to consent to any requested conversion, which provides them leverage to renegotiate the terms of conversion.

provided further, that any demand must be made by the holders of not less than a majority of the then outstanding Series A.[13]

***(7) Voting Rights*:** Except (i) with respect to the election of directors as described under "Board Representation and Meetings" on the following page, (ii) with respect to certain protective provisions as described under "Protective Provisions" below, and (iii) as expressly provided herein, the holders of Series A will vote with the holders of Common Stock as a single class on all matters. The holders of Series A will have the right to that number of votes equal to the largest number of full shares of Common Stock issuable upon conversion of the Series A.

***(8) Protective Provisions*:** Without the consent of the holders of at least a majority of the Series A (voting as a single class), the Company shall not, and will not permit any subsidiary to, (i) create or issue any equity security senior to or on a parity with the Series A as to dividend, liquidation or redemption rights; (ii) sell all or substantially all the assets of the Company or any subsidiary or consolidate or merge the Company or any subsidiary; (iii) amend the Articles of Incorporation or Bylaws of the Company; (iv) redeem any capital stock of the Company (other

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[13] Rights to demand registrations on a Form S-3 (a short registration form available to certain public companies) typically are also sought. Key issues to focus on include the number of demand rights, when demand rights are exercisable, the minimum size (in terms of dollars and holder participation) for a demand registration and "cut-back" rights in the event the size of an offering is reduced by underwriters. Also, the company should seek a "lock up" of at least 180 days from each investor following an IPO.

than redemptions pursuant to paragraph 3 above and pursuant to agreements with employees or consultants of the Company); or (v) take certain other actions materially affecting the Series A.[14]

Information Rights: So long as any of the Series A is outstanding, the Company will deliver to each holder of Series A annual and quarterly financial statements and other information reasonably requested by a holder of the Series A. Holders of Series A will also be entitled to advise the Company as to its management and to discuss its affairs with key employees.[15]

Use of Proceeds: The proceeds from the sale of the Series A will be used for general working capital purposes consistent with the Company's Business Plan dated ________________, 200__.

Board Representation: The Articles of Incorporation and the Bylaws will provide that the authorized number of Directors will be five. Pursuant to the Articles of Incorporation, the Series A (voting as a class) will have the right to elect two directors.[16]

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[14] Each venture firm typically has certain matters over which it wants a "class veto." The matters listed in (i)-(iv) are fairly standard in all venture investments. It is often possible to limit other requested veto rights or shift them to the Board for its approval, particularly through the use of "super majority" Board approval provisions.

[15] Venture investors often seek extensive information and reporting provisions that may include monthly financials, annual budgets and forecasts, reports from management, SBIC reporting and similar matters.

[16] This provision may be implemented through use of a shareholder voting agreement. Care should be taken to define clearly the designation rights and qualifications (management, investor or outsider) of each Board seat.

The Bylaws will provide that the Company will indemnify Directors to the fullest extent permitted by law.[17] Expenses of Directors in attending meetings and otherwise performing the function of Directors will be borne by the Company.[18]

Shareholders Agreement: All existing shareholders (Common and Series A) will execute a Shareholders Agreement with the Company pursuant to which the Company and the holders of Series A and Common Stock have a right of first refusal with respect to any shares proposed to be sold by any shareholder.[19] The Investors will also receive co-sale rights on any proposed sale of shares by an existing shareholder. The Shareholders Agreement will also give the Company and the holders of Common Stock and Series A the right to repurchase certain of the shares of a management member in the event his employment with the Company terminates. The number of shares and the price per share will depend on the reason for termination.[20] Each of the Investors

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[17] Typically, investors will also seek Bylaw provisions that define the scope and composition of Board committees and that permit them to call Board and shareholder meetings. Directors' and officers' liability insurance may also be required.

[18] In some investments with multiple investors, observer rights are granted to investors who are not directly represented on the Board, which permit them to send a representative to attend Board meetings in a nonvoting capacity. The number of observers should be limited and expenses of observers typically are not reimbursed.

[19] Many investors will resist imposing any restrictions on transfer on their own shares.

[20] These provisions are critical and should be negotiated up front in detail if possible. Repurchase rights in the event of termination (upon death, disability, at employee's will or by the company with or without cause) can directly and materially affect the value of the entrepreneur's interest in the company.

will be entitled to purchase its pro rata share of any proposed new issuance of equity securities by the Company.[21] The Shareholders Agreement will terminate upon a Qualified Public Offering, certain mergers or a sale of substantially all the Company's assets.

EmploymentAgreements: John Executive and Samuel Scientist (key employees) will each enter into an employment and noncompetition agreement with the Company in connection with the Series A financing.[22]

Key Person Insurance: The Company will be required to obtain prior to closing and maintain at all times key person insurance insuring the lives of John Executive and Samuel Scientist of at least $1,000,000 each, with all proceeds payable to the Company.

PurchaseAgreement: The purchase of the Series A will be made pursuant to a Preferred Stock Purchase Agreement. Such Agreement will contain, among other things, appropriate representations and warranties of the Company and the Investors, covenants of the Company and the Investors reflecting the provisions set forth herein and other restrictive negative and affirmative

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[21] Investors typically seek "preemptive rights" to purchase their pro rata share of new issuances. These rights may be placed in the Articles of Incorporation or in a purchase or shareholders agreement. It is customary to negotiate a number of exceptions to these rights. It may also be possible to extend these rights to all shareholders.

[22] See "Founder Employment Agreements" above for a description of the topics that need to be addressed by these agreements.

covenants customary for transactions of this type[23] and appropriate additional conditions of closing, including, among other things, qualification of the shares under applicable Blue Sky laws and the filing of amended and restated Articles of Incorporation to authorize the Series A. Until the Purchase Agreement is signed by both the Company and the Investors, no binding obligation will exist on the part of any party to consummate the transaction. This Summary of Proposed Terms does not constitute a contractual commitment of the Company or the Investors.

Expenses: The Company will reimburse the investors for the reasonable legal expenses of a single counsel to the investors, not to exceed $15,000, incurred with respect to the transactions described herein.[24]

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

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[23] Many investors have extensive negative and affirmative covenants that they seek to impose on a company that are similar to those found in loan agreements. These covenants can also include specific financial ratios that must be maintained and may also include penalties, including the right to force redemption or to elect additional members to the Board of Directors, in the event of breach.

[24] This is a customary provision, although the amount is subject to negotiation. If the company's attorneys will be responsible for drafting the documentation, the investor's counsel allowance is typically between $5,000 and $15,000, depending on the complexity of the transaction and the company. Add $10,000 to $20,000 if investor counsel is drafting the documents.

NOTES

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