

§ 2.02 Basic Term Sheet

[1]—Preamble

The preamble has a dual purpose: (1) to set out the parties to the transaction, and (2) to make clear that the Term Sheet is not the definitive agreement but rather a mere outline of the material terms among the parties. Most of the provisions of the Term Sheet are, in fact, non-binding on the parties.

**“TERM SHEET FOR PROPOSED INVESTMENT IN
[COMPANY NAME]”
[DATE]**

This document shall serve to confirm the agreement between one or more venture capital funds affiliated with Half-Wit Ventures, Corp., (collectively, the “Fund”) and [COMPANY], a [JURISDICTION] corporation (the “Company”) with respect to a proposed investment in the Company (the “Transaction”) by the Fund and certain other investors (collectively, the “Investors”). This document (the “Term Sheet”) does not address all issues and matters that may arise in the course of preparing a definitive purchase agreement (the “Purchase Agreement”) and related documents, but rather is intended as an outline of the material terms of our understanding with regard to the proposed investment. Set forth below is a summary of the material terms of our understanding.”

[2]—Brief Summary of Transaction

The brief summary of the transaction is helpful to all parties involved because it sets out the percentage ownership and economic terms of the investment.

“Brief Summary of the Transaction: The investor will invest \$[DOLLARS] as equity (the “Investment”) based upon a pre-money valuation of \$[PREMONEY] on a fully diluted basis, including a [PERCENT]% unallocated stock option pool for employees, as further discussed below. The Investment will be allocated as follows:

The Fund \$[_____]; Other investors—\$ [if any].

The Investors will be issued, in the aggregate, [# SHARES] shares of Series [SERIES LETTER] Preferred Stock of the Company (the “Preferred Shares”) representing [PERCENT] of the capital stock of the Company on a fully diluted basis (including the

additional stock option pool reserve) following the closing of the Investment.

The price per Preferred Share will be \$[PER SHARE] per share (the “Purchase Price”).”

[3]—Outstanding Capitalization

This provision should clearly set forth the percentage ownership of the respective shareholders of the company upon completion of the investment.

“**Outstanding Capitalization:** See attached capitalization table, Appendix A, which sets forth the ownership of the Company immediately following the proposed investment.”

[4]—Closing Date

It is in the company’s interest to lock in a hard Closing Date—and for a date as soon as possible. Once the company signs this Term Sheet it will be prohibited to solicit competing offers. On the other hand, the venture capital firm often views the Closing Date as a “soft” target date and would prefer to have as much time as it can obtain, in order to give it ample opportunity to complete all of its legal and business due diligence.

This provision is frequently amended during the due diligence phase, as the parties often extend the period if they are working in good faith towards a closing of the financing.

“**Tentative Closing:** On or before [CLOSING DATE] (the “Closing”).”

[5]—Use of Proceeds

The venture capital firm prefers a clear description of the use of proceeds, and in fact may directly tie such use into a pre-approved business plan. The company, however, would prefer as much flexibility as possible and would look to use broad language such as “for working capital purposes.”

“**Use of Proceeds:** The investment will be used [to fund product development, commence the Company’s marketing efforts, fund working capital, and recruit a management team.]”

[6]—Stock Option Plan

The venture capital firm wants to insure that the management team and employees are properly incentivized with equity based stock options. Stock options also provide a valuable tool to align the economic interests of the management team and the investors.

The key issues of negotiation will be the size of the option pool and who gets to participate. While the range of the number of stock options in a pool may vary widely, many companies, particularly those in the technology sectors, focus on a range of 15% to 22% with the senior management team owning approximately 8%-10%. This percentage of ownership, however, varies from industry to industry and also depends in part on whether the management team owns equity directly.

“Stock Option Plan: [_____ SHARES] shares of the Company’s Common Stock shall be allocated to the Company’s stock option plan (the “Option Plan”) which shall represent [_____] % of the capital stock of the Company on a fully diluted basis after the Closing.”

[7]—Representation and Warranties

For a company in its very early stages, the venture capital firm may require that representations and warranties be provided by the individual founders. Conversely, the founders will only want the company to provide the representations and warranties.

“Representations and Warranties: Standard representations and warranties given by the Company and the Investors in connection with the sale of a significant block of capital stock.”

[8]—Dividends

Generally, Preferred Stock has a dividend component. The dividends provisions serve two purposes. By including dividends, the Preferred Stock can be viewed as a different security than the Common Stock and hence provides another reason for Common Stock options to be granted to employees at a discount to the purchase price for Preferred Stock. Further, the dividend is another indication of differentiation from the Common Stock and thus may eliminate a potential Section 83(a) tax issue for the founders. The dividend component adds an extra rate of return for the investors, as well.

Dividends may be cumulative or non-cumulative. Cumulative dividends mean that the dividends accrue from the date of investment. Non-cumulative dividends mean that the dividends are only paid as they are declared. Additionally, dividends may accrue automatically

or only if declared by the Board of Directors. Venture capital firms prefer cumulative dividends while the company will prefer non-cumulative dividends and only paid if declared by the Board of Directors. Dividends may also be paid in kind (a “PIK”).

“Dividend Policy: Holders of the Preferred Shares shall be entitled to receive [cumulative] dividends in preference to any dividend on the Common Stock at the rate of [_____] of their original price per share, per annum, whenever funds are legally available, [when, if, and as declared by the Board of Directors.] The Preferred Shares will also participate pro rata in any dividend paid on the Common Stock on an as-if-converted basis. [Dividends, at the sole option of the Investor, may be payable in Common Stock, valued at the fair market price (calculated based on the closing price the previous five trading days, if publicly traded, or, if not publicly traded, calculated in good faith, by the Board of Directors using the best information then available).]”

[9]—Liquidation Preference

The most basic liquidation preference is a non-participating preference whereby the investors are entitled to an amount equal to the return of the original purchase price. The venture capital firm wants the liquidation preferences to be paid not only upon a liquidation event, but also at their option, upon a sale or merger, or a public offering of the company. The liquidation preference for a public offering is a recent phenomenon and often not included. Venture capital firms also want to receive accrued dividends upon a liquidation. With a non-participating preference, the investors are entitled to receive either their liquidation preference *or* convert to common and receive their pro-rata interest as a common stock holder.

“Liquidation Preference: In the event of any liquidation, [sale, merger] [public offering], consolidation or winding up of the Company, the holders of the Preferred Shares shall be entitled to receive, in preference to the holders of all other issued capital stock, an amount equal to the original purchase price of each Preferred Share [plus accrued but unpaid dividends] (the “Liquidation Preference”). After the payment of the Liquidation Preference, the holders of the Common Stock shall be entitled to receive any remaining assets of the Company.”

[10]—Conversion Ratio; Anti-Dilution Adjustment

Generally, Preferred Stock is initially converted on a one for one basis into Common Stock. The conversion ratio is usually subject to

adjustment if preferred shares are issued at a lower price (price protection)—but excluding certain specified exceptions, or if there is a structural change to the capitalization of the company, such as a stock split.¹

“Conversion Ratio and Anti-dilution Adjustment: Holders of Preferred Shares shall have the right at any time after the date of issuance to convert their shares into Common Stock of the Company at an initial conversion rate of one-to-one, subject to [{broad-based} {narrow-based} weighted average] [full ratchet] anti-dilution price protection and other customary adjustments.”

[11]—Automatic or Mandatory Conversion

The company strongly desires the Preferred Stock to convert into Common Stock upon completion of a public offering. In fact it is unlikely that an underwriter would be willing to proceed with a public offering unless the Preferred Stock would convert to Common Stock upon completion of the offering. From the venture capital firm’s perspective, the public offering must be sufficiently significant and material in terms of dollars raised and valuation in order for it to agree to give up its preferences and seniority.

“Automatic Conversion: Each of the Preferred Shares shall be automatically converted into Common Stock of the Company at the then applicable conversion rate in the event of an underwritten public offering on a firm commitment basis netting the Company [\$_____] based on a pre-money valuation of not less than [\$_____] (“Qualified IPO”).”

“In addition, each share of the Preferred Shares shall be automatically converted at the then applicable conversion rate upon the written consent of a majority in interest of the Preferred Shares.”

[12]—Voting Rights

The holders of the Preferred Stock may desire special voting rights as a class on certain matters. In certain rare instances, where the founder is a recognized and irreplaceable asset to the enterprise, he or she too may want to obtain special voting rights. Typically, however, holders of the Preferred Stock will vote on an as-if-converted basis with the Common Stock holders, except with respect to certain protective provisions.²

¹ For an in depth discussion of the various anti-dilution price protection provisions, see Chapter 6 *infra*.

² See § 2.02[19] *infra*.

“**Voting Rights:** The holders of Preferred Shares shall vote together with the holders of Common Stock on an as-if-converted basis.”

[13]—Registration Rights

Because the preferred shares being issued are not registered for resale, the investors will request the right to require the company to register its shares for sale. Registration rights requested will include both “demand” and “piggyback” rights. Since the holding period under Rule 144 has been reduced to one year, the negotiations regarding the number and types of registration rights have become significantly less contentious.³

“**Registration Rights:** Upon the vote of a majority of the Common Stock issuable upon conversion of the Preferred Shares, the holders of such shares shall be entitled to: (i) [two] demand registrations on Form S-1 (or any successor form) at any time commencing 180 days after an initial public offering of capital stock of the Company (an “IPO”); (ii) unlimited “piggyback” registration rights and (iii) [two] demand registrations on Form S-3 (or any successor form), if such form is available to the Company, provided that the Company shall not be required to file any Form S-3: (x) where the aggregate offering price for the registered shares is less than \$500,000, or (y) if the Company delivered notice of its intent to file a registration statement within 90 days. The Company shall pay all registration costs and fees, including the reasonable fees and expenses of one counsel for the selling shareholders, other than underwriters discount and selling commissions incurred in connection with demand and company registrations.

[{FOUNDERS} shall also have “piggyback” registration rights subject to the amount of shares that they are registering and are limited to the amount of shares the Investors are registering. In the event of an underwriter cutback all shares held by a founder being registered shall be cut back prior to any shares held by the Investors being registered.]”

[14]—Lockup

An underwriter of a public offering requires that virtually all shareholders (and certainly all major shareholders) refrain from selling

³ For a detailed discussion of registration rights agreements, see Chapter 8.

their shares in the six-month period following an initial public offering. The underlying rationale for this requirement is that it would be difficult to sell shares of the company to the public if the insiders were immediately selling and cashing out their positions. Accordingly, it is both in the company's interest and in the investors' interest to make sure that all shareholders sign onto this lock-up at this point in time so that no person has the leverage later on to disturb a potential public offering.

“Lock Up: Holders of the Preferred Shares and holders of all other issued capital stock will agree to lock-ups of up to [180] days following the IPO.”

[15]—Information and Reporting

The investors want to insure that that they receive current and accurate reporting of financial and other critical metrics relating to the company.

“Information and Reporting: Prior to a Qualified IPO, the Company shall provide to the Investors: (i) audited financial statements within 90 days after the end of each fiscal year; (ii) unaudited financial statements within 45 days after the end of each fiscal quarter; (iii) a profit and loss statement and balance sheet on a monthly basis; and (iv) such other critical metrics as reasonably requested by the Investors. The Investors will have the right to inspect the books and records of the Company during reasonable business hours upon reasonable prior notice to the Company.”

[16]—Participation in Future Offerings

The investors request pre-emptive rights so that they can limit dilution of their ownership. Pre-emptive rights give investors the right to invest additional capital in future financings so that they can maintain their ownership position.

“Participation in Future Offerings: The Investors shall have the preemptive right to participate in any future sales of securities by the Company (other than (i) shares or options issued pursuant to the Option Plan and (ii) shares issued as consideration for an acquisition or merger approved by the Board of Directors), on a *pro rata* basis based on each Investor's ownership percentage prior to such offering.”

[17]—Transfer to Affiliates

An investor may request the flexibility to transfer the investment to an affiliated entity. Additionally, individual investors may have estate tax planning that would require a transfer.

“Transfer to Affiliates and/or Partners: An Investor may, at its option, transfer any or all of its investment to its affiliates.”

[18]—Board of Directors

There is a broad range of acceptable outcomes relating to the number and make-up of the Board, and often this section of the Term Sheet is subject to much negotiation. Many venture capital firms prefer a smaller Board of Directors for early stage companies so that a manageable core group of professionals can move quickly to make decisions. Further, a number of venture capital firms require that the investors as a group have control of the Board. Arguably, it is in the interest of all parties involved to have one or more independent directors installed on the Board, particularly as a company anticipates a potential liquidity event.

Many corporate governance experts recommend an odd number of directors so as to avoid the potential for deadlock votes. Sometimes where there are a limited number of available seats, investors may request “Board Observer Rights.” Board Observers are entitled to the same information rights as actual Board members and may attend all Board meetings, but they are not entitled to vote on any matters brought before the Board.

“Board of Directors: The Company shall have a Board of Directors with [five] [seven] seats. [Two board members shall be appointed by the Investors, and two board members shall be appointed by the current stockholders. The fifth seat shall be a director mutually agreed upon by the Company and the Investors.] [Additionally, _____ shall have the right to appoint a Board Observer].

[19]—Protective Provisions

Most venture capital firms believe these “protective” provisions are necessary and appropriate to protect their rights. These provisions are often subject to much negotiation, although it is difficult for a company to argue persuasively against any provision that protects the Preferred Holders’ rights regarding seniority and preferences.

“Consents: For so long as [PERCENTAGE]% of Preferred Shares remain outstanding, the Company will not take any of the

following actions without the approval of the holders of [2/3] [a majority] of the Preferred Shares then outstanding: (i) any action which results in any merger, corporate reorganization, sale of control, or any transaction in which all of substantially all of the assets of the Company are sold; (ii) a material and adverse modification of rights, preferences or privileges of the Preferred Shares, whether by merger or otherwise; (iii) an increase in the number of authorized Preferred Shares; (iv) the creation of any class of shares senior to or on parity with the Preferred Shares or the issuance of any securities which are issued, convert into Common Stock, at a price per share less than the Purchase Price; (v) the reclassification of outstanding capital shares of the Company; (vi) the modification of the Company's Certificate of Incorporation or Bylaws, if such action would materially and adversely alter the rights of the Preferred Shares, whether by merger or otherwise; (vii) the incurring of any debt outside the ordinary course of business; (viii) a material change in the Company's business plan; (ix) the making of any assignment for the benefit of creditors or the commencement of any bankruptcy, dissolution, termination of corporate existence, or any other similar action; (x) a change of the Company's auditor; (xi) expansion of the number of Directors constituting the Board of Directors; (xii) the creation or elimination of any subsidiaries; and (xiii) any transactions with affiliates of the Company."

[20]—Directors and Officers Insurance

In our litigious world it is important that companies pay for directors and officers insurance so that they can attract qualified individuals for these positions of responsibility.

“Directors and Officers Insurance; Expenses: [Immediately upon Closing] [On or prior to Closing], the Company [will undertake to obtain] [shall have obtained] Directors and Officers insurance in [a standard amount] [an amount of not less than \$_____]. The Company shall also reimburse the reasonable out-of-pocket expenses of Directors and Observers incurred in connection with attendance at board meetings and other undertakings on behalf of the company.”

[21]—Employment Agreements; Key Man Insurance

The last thing a venture capital firm wants is to invest a significant amount of capital in a company only to learn that its key employees have quit and have formed a competitive business. Therefore, a venture capital firm often requires that all key employees have employment contracts. These employment contracts include non-competition and

non-solicitation provisions. Additionally, some venture capital firms require “key man” insurance for one or more key senior executives.

“Employment Agreements; Key Man Insurance: At or prior to Closing, the Company will enter into [two] year employment agreements with the CEO and other senior management, determined at the discretion of the Investors, in which they agree to devote full time to the affairs of the Company. Such employment agreements shall include confidentiality and non-solicitation provisions and a covenant not to compete. Additionally, prior to the Closing, the Company will obtain key man insurance in the amount of \$_____ with respect to _____.”

[22]—Stockholders Agreement

The venture capital firm usually requests a right of first refusal to acquire the other major shareholders’ shares and the rights to “drag-along” all major shareholders in the event of a sale.⁴

“Stockholders Agreement. As a condition to the Closing, each of the current controlling stockholders of the company and the Investors shall enter into a mutually agreeable stockholders agreement, granting the Investors customary rights of first refusal and co-sale rights with respect to any sale of equity securities.”

[23]—Standstill

The venture capital firm does not want to expend the time and money to complete its due diligence unless it is certain that the company is not using its offer to start an auction bidding process with other potential investors. Accordingly, the venture capital firm will request a standstill agreement, which it would try to make as long as possible. The company, however, will want a standstill agreement with a very short fuse.

“Standstill: The Company agrees that prior to [CLOSING DATE], it shall not permit any of its stockholders, officers, directors, employees, agents, or representatives (including, without limitation, its attorneys and accountants) to directly or indirectly initiate, solicit, or encourage discussions, inquiries, or proposals, or to participate in any negotiation or discussion for the purpose or with

⁴ A detailed discussion of “Stockholder Agreements” and “co-sale rights” is set forth in § 2.02[22] and § 10.02[4], respectively.

the intention of leading to any proposal concerning the sale of the assets or any of the capital stock of the Company. The parties agree to use their best efforts to move towards a prompt Closing.”

[24]—Confidentiality

It is arguably in the interests of all parties concerned to keep the discussions regarding the potential investment confidential.

“Confidentiality: Each party shall insure that all confidential information which such party or any of its respective officers, directors, employees, attorneys, agents, investment bankers or accountants may now possess or may hereafter create or obtain relating to the financial condition, results of operations, businesses, properties, assets, liabilities or future prospects of the other party, any affiliate of the other party, or any customer or supplier of such other party or any such affiliate shall not be published, disclosed or made accessible by any of them to any other person or entity at any time or used by any of them, in each case without the prior written consent of the other party; provided, however, that the restrictions of this sentence shall not apply (i) as may otherwise be required by law; (ii) as may be necessary or appropriate in connection with the enforcement of this Agreement or (iii) to the extent such information was in the public domain when received or thereafter enters the public domain other than because of disclosure by the other party. Each party shall, and shall cause all of such other persons and entities whom received confidential data from time to time to deliver to the other party all tangible evidence of such confidential information to which the restrictions of the foregoing sentence apply at such time as negotiations with respect to the Transaction are terminated.”

[25]—Public Non-Disclosure

Similar to the Confidentiality Section, it is arguably in the interests of all parties to insist that there be no public disclosure of the Transaction unless mutually agreed.

“Public Non-Disclosure: Neither the terms of this Term Sheet nor any other document required to be executed in order to consummate the Transaction, nor any termination of negotiations relating to the Transaction, shall be publicly disseminated by either party, either by oral or by written disclosure, without the prior written approval of the other party, which approval shall not be unreasonably withheld.”

[26]—Expenses

Typically the company is responsible for the expenses of the transaction, including the legal fees of the venture capital firm, subject to a cap for such legal fees. The amount of the cap is almost always the topic of a negotiation.

“Expenses: The Company shall pay from the proceeds of the Investment the expenses (including reasonable legal fees and due diligence expenses) incurred by the Fund in connection with this transaction up to a maximum of [\$50,000]. In the event this transaction does not close (other than a breach of the “standstill” provisions above), each party shall be responsible for its own legal costs and expenses. If the Company breaches such “standstill” provisions, it shall be responsible for all reasonable legal fees and due diligence expenses of the Investors, plus liquidated damages of \$_____ payable to the Investors.”

[27]—Contingencies

It is important to remember that the Term Sheet is a non-binding letter of intent only, except for certain specific provisions. There will still be significant issues to negotiate as the final documents are drafted.

“Contingencies: This offer shall remain open until [TIME, DATE] and is contingent upon the completion by the Investors of due diligence, final approval by the Fund’s Investment Committee and completion of satisfactory legal agreements incorporating the terms hereof.

It is understood that this Term Sheet is intended as a letter of intent only and while the parties hereto agree to in principle to the contents hereof, neither party shall have any legal obligations to the other as a result of executing this Term Sheet, other than those specific obligations contained in the above sections entitled “Standstill,” “Public Non-Disclosure,” “Confidentiality,” “Expenses,” and “Contingencies.”