

**Business Law Section of the Utah State Bar
January 13, 2010**

Raising Capital in a Down Economy

1. How Has the Economy Affected Terms?

- term sheet / current trends
 - pre-money valuation
 - equity / debt
 - dividends
 - liquidation preference
 - anti-dilution rights
 - performance / forfeiture provisions
 - protective provisions / board composition and approval rights
 - redemption rights
 - founder vesting provisions
 - warrant coverage
 - exit mechanisms

2. Other Considerations.

- FFF / Angels / VC's
- choice of entity
- jurisdiction of formation
- conflicts

3. What is Your Role?

- legal advisor
- business advisor
- educator / mentor
- facilitator
- company / principal shareholders

4. How Can You Make Money?

- creative arrangements
- success-based
- deferred
- equity
- fixed fee
- investor / company representation

David R. Rudd
Ballard Spahr LLP
201 South Main Street, Suite 800
Salt Lake City, UT 84111-2221
801.517.6829

ANGEL INVESTING

Drafted to be part of

HOW TO START AND GROW A LIFE SCIENCE COMPANY

Practical Advice for Start-up Companies & Incubators

Compiled by Ballard Spahr LLP

Most development stage life science companies need significant outside capital in order to meet their business objectives. Founder resources are typically limited, government grants can't be relied on to fully cover all needs on a timely basis, and a long development cycle may be required before income can be generated. Qualification for commercial loans is still in the future and venture capitalists are looking to invest larger sums of money in later stage deals with a more proven track record. As a result, many promising early stage companies turn to angel investors ("Angels") to provide needed capital. This chapter provides information to aid entrepreneurs as they consider pursuing investment from Angels.

What is an Angel: Anyone with sufficient resources to allocate a portion to invest in early stage companies. Often, someone who has been through the same entrepreneurial process and enjoyed one or more successful exits. Angels invest their own funds, as compared to venture capitalists ("VCs") who typically direct the investment of other people's money, which has been pooled into professionally managed funds.

Securities law compliance: Although beyond the scope of this chapter, remember that whenever a start-up company issues stock or other securities to Angels, the transactions must be effected in compliance with applicable state and federal securities laws. That means an exemption from registration requirements must be perfected, and anti-fraud rules (disclosures, no material misstatements or omissions) must be complied with.

Filling the gap: Most current VC funds manage too much money to focus on small, early stage deals. Furthermore, the relatively small number of VCs can consider and invest in only a small percentage of promising, early-stage life science companies. As a result, Angels fill an important role, bridging a significant gap. Most people think of VCs as the expected financing route to follow for funding promising start-up companies, but Angels collectively invest about as much and participate in many more transactions. So most entrepreneurs are likely to have many more transactions with Angels than VCs.

The motivation to invest: VCs owe fiduciary duties to their investors. As a result, their investment decisions are based solely on potential return on investment. While Angels are also concerned about ROI, that is not always their only motivation. Other factors that may impact their investment decision include: passion for a particular industry or product; a desire to remain involved in the entrepreneurial process; an intent to mentor the new generation; or a goal to give back to the community. This more complex motivation matrix may impact an Angel's approach to analysis of a deal or investment terms, or willingness to take a hands-on role.

Angel investment models: Angels may operate individually, or through loosely affiliated networks, in which they share due diligence responsibilities and related functions. Currently, many Angel groups are more formalized, and may be led by a manager who may sort through deal-flow, schedule presentations, poll Angels for interest, and assist with due diligence and transaction negotiation. The manager may be compensated through dues or some kind of participation in transactions, such as warrants. Some Angel groups may actually create a fund, with participating Angels all contributing. Whether or not the group has a fund, Angels may be invited to participate individually. Sometimes a new entity may be created for each investment, to include those members of the group who have decided to participate. To the extent the group is asked to participate on a Board, or to provide mentoring or advisory services, the members generally allocate such assignments so as to even-out their obligations across their portfolio.

Angel investment terms: Angels typically invest on terms that are very similar to those often proposed by VCs. Preferred stock is the most common investment, although convertible debt is sometimes used. Convertible debt often provides for conversion at some discount from the next sizable equity financing price. However, Angels frequently come in early because they believe that the valuation at that early stage can be much lower than it will be when VCs first come on board. Such Angels may fear losing much of the advantage of the early investment by basing the conversion rate at the next stage investment price, even at a significant discount. Some Angels, perhaps due to their relationship with an entrepreneur, or the lack of sophistication or ability, may not perform significant due diligence regarding the valuation of a start-up. If they simply accept the valuation proposed by management, there could be problems down the road if the next round of investors determine the value is less than what the Angels invested at, unless anti-dilution protections have been negotiated.

The transition to VCs: If a company plans to seek funding from VCs, but needs Angels as an initial step to bridge the funding gap, several concerns should be addressed:

- If the Angel has negotiated significant rights and protections, is the Angel willing to re-negotiate once the VCs make their investment? If not, the Angel's unwillingness may complicate the new investment.
- If the Angel has been granted a Board seat or given a management position, will the Angel be willing to step-down once the VCs invest?
- Does the Angel appreciate the value of VC investors coming to the table, and is the Angel willing to accept a diminished role, with decreased rights once the VCs invest? In short, work with Angels who understand their role in the funding chain, and who negotiate terms consistent with a subsequent VC round, with the understanding that to accommodate new investors, earlier stage investors may be required to modify their investment position.

Chris Anderson

David Rudd

**MEMORANDUM OF TERMS FOR
PROPOSED ISSUANCE OF
SERIES __ PREFERRED STOCK OF
[]¹**

This memorandum summarizes the principal terms of a proposed investment by [] and/or certain affiliates or other investors (collectively, the "Investors"), in equity securities of [], a [] corporation (the "Company").² [This memorandum is not a binding agreement between the Company and the Investors, but is merely a statement of intent and proposed terms and other provisions.]³

Introduction

The Company presently has an authorized capitalization consisting of [] shares of Common Stock (the "Common Stock") [and _____ shares of Preferred Stock ("the Preferred Stock")], of which _____ shares have been designated as Series __ Preferred Stock and _____ shares have been designated as Series __ Preferred Stock]. As of the date hereof, the Company has issued [] shares of Common Stock [,][and][_____ shares of [Series __] Preferred Stock] [and _____ shares of Series __ Preferred Stock]. The Company has reserved [] shares of Common Stock for issuance under stock incentive plans and arrangements for the benefit of key employees, consultants, directors and officers of the Company.

¹ This memorandum is intended to be illustrative of significant terms and conditions that are common in venture capital financings, but does not constitute a comprehensive or exhaustive listing of possible provisions. Most angel groups structure their investments on similar terms and conditions. Each particular transaction will include terms and conditions tailored to such transaction and the parties involved, and will reflect, among other things, the agreed-upon valuation of the Company involved, the particular stage of financing, the existing capital structure, the rights of existing shareholders of the Company, the current investment climate, and other relevant variables. Venture capitalists typically structure their investments as purchases of shares of convertible Preferred Stock, which have preferential rights such as those referenced in this memorandum. A side benefit to the issuer from structuring a venture investment as an issuance of Preferred Stock is that it can justify a much lower price for its Common Stock (which may be allocated to employees and others having a relationship with the Company), which does not enjoy the same rights and preferences, than the value placed on the Preferred Stock to be issued in the venture capital financing.

² While limited liability companies are popular business vehicles and offer great organizational flexibility to early stage companies, the corporation continues to be the most commonly used form of entity for the typical venture backed company. Venture investors seem to be more comfortable with the corporate entity, and the corporation facilitates frequent changes in, and additions to, the ownership group, as well as the implementation of incentive arrangements for employees. Angel groups, however, tend to be more open to using an LLC structure.

³ Typically, a memorandum of terms (or term sheet) is not intended to be construed as a contract binding on either party. From the investors' perspective, they will not want to be bound in any way until all conditions precedent have been met, such as completion of due diligence and execution of a definitive purchase agreement. Often, as with this example, the memorandum is not even signed by the parties.

Ballard Spahr LLP

Summary of Proposed Financing Terms

An equity financing based on the issuance of shares of the Company's Series __ Preferred Stock (the "Series __ Preferred") is proposed on the following terms:

Amount of Financing: \$ _____⁴

Type of Security: Series __ Preferred⁵

Pre-Money Valuation: _____⁶

Number of Shares: _____⁷

Price Per Share: \$ _____ (the "original purchase price")

Anticipated Closing: The closing of the financing transaction is expected to occur on or before _____, 20__.

The Proposed Investor Group:

[Alternative one: Name	Amount of Investment
_____	\$ _____
_____	\$ _____
_____	\$ _____
Total	\$ _____]

⁴ The amount of the investment is often given as a range, depending on whether the investor group has already been assembled, or if the investors want a staged pay-in, with their investment to be made in installments, if and when the Company achieves specified milestones.

⁵ In certain circumstances, the investors may wish to structure their investment as debt, with either a convertible equity feature or detachable warrants. Debt structures are often disfavored in early stage deals, however, as they offer little tax advantage to companies which typically lack significant taxable income, and generally wreak havoc on an issuer's balance sheet.

⁶ The pre-money valuation of the Company will usually be heavily negotiated and will drive many issues concerning the rights of the various parties and the structure of the investment. Investors use a number of different methods to determine a Company's valuation and the price they will pay for their investment, from a discounted revenue stream approach based on business plan projections, to a more arbitrary figure based on a desire to own a predetermined percentage of the Company in return for the anticipated level of funding needed to achieve a specified milestone. Sometimes, a convertible debt structure is used when the Company and the investors cannot agree upon a reasonable pre-money valuation of the Company.

⁷ Where the amount of the investment is given as a range or subject to adjustment, the number of shares will also be variable.

Rights, Preferences, Privileges
and Restrictions of Series
__ Preferred Stock:

[Alternative two: _____ (“Lead Investor”),
and one or more additional Investors to be identified or
approved by Lead Investor.⁸]

(1) Dividend Provisions:⁹

(a) *Preferential Dividend*: [Alternative one: The holders of Series __ Preferred will be entitled to receive [non]cumulative dividends [, prior and in preference to any dividend on the Common Stock [or _____ Preferred Stock]], at the rate of _____ percent (__ %) per annum on the [sum of the] original purchase price [and any accrued dividends][, when and if declared by the Board of Directors.] [Dividends will accrue and cumulate on a _____ basis, whether or not declared by the Board.] [The [cumulative] dividend shall be payable upon a sale or liquidation of the Company or the consummation of the initial public offering of the Company’s securities.] [Alternative two: The holders of the Series __ Preferred shall be entitled to receive dividends when, as and if declared by the Board of Directors.]

(b) *Participation With Common [and other Preferred Stock]*: If a dividend is declared with respect to the Common Stock [or any other series of Preferred Stock], then an equivalent dividend per share (determined on an as-if converted basis) will be declared and paid with respect to the Series __ Preferred.

(2) Liquidation Preference: In the event of any liquidation or winding up of the Company, the holders of Series __ Preferred will be entitled to receive, prior to and in

⁸ For a variety of reasons, the Lead Investor may want other investors to participate in the financing. The Company (or the Lead Investor, especially if multiple closings with new investors contemplated) may ask for approval rights with respect to any co-investors, although in any event the definitive agreements with all investors will be subject to approval and execution by the Company.

⁹ Generally, a dividend must be paid to the holders of Preferred Stock before any dividend is paid to the holders of Common Stock. This dividend may be non-cumulative and discretionary, or it may be cumulative so that it accrues from year to year until paid in full. The nature of the dividend preference granted to investors is often a focus of negotiations. Since early stage companies are rarely in a position to pay current cash dividends, a dividend payment or accrual requirement gives leverage to the investment group, and may result in the investors being able to convert their preferred investment into a greater number of shares of Common Stock (or to receive a greater portion of the proceeds of a sale transaction) than would otherwise be the case, thereby increasing their equity position. Companies should be wary of dividends which compound, since for an investment which is in place for several years, the effect of compounding can be significant. A dividend provision may sometimes provide for issuance of additional shares or other payment in kind provision.

preference over the holders of Common Stock [and Series ___ Preferred Stock] [but pari passu with the outstanding shares of Series ___ Preferred Stock], an amount per share of Series ___ Preferred equal to [___ times] the original purchase price, plus any [accumulated or accrued and] declared but unpaid dividends. [After payment of such sum, [and after the holders of Series ___ Preferred Stock receive a \$___ secondary preference] [and the holders of Common Stock receive a \$___ per share secondary preference,] the holders of Series ___ Preferred, [Series ___ Preferred Stock] and Common Stock will participate pro rata (determined, in the case of Preferred Stock, on an as-if converted basis) in any other liquidating distributions.]¹⁰ A consolidation or merger of the Company [in which the Company does not survive] or a sale of all or substantially all of its assets will be deemed to be a liquidation or winding up for purposes of the liquidation preference [unless otherwise determined by the holders of at least a majority of the then outstanding shares of Series _____ Preferred].¹¹

(3) Voluntary Conversion: The holders of Series ___ Preferred will have the right and option to convert all or any portion of such shares at any time into shares of Common Stock. One share of Series ___ Preferred shall initially be convertible into one share of Common Stock.

¹⁰ A liquidation preference typically refers to the right granted to the holders of a series of Preferred Stock to receive a specified fixed amount before any assets are distributed to holders of Common Stock. A series of Preferred Stock is referred to as a "participating" preferred, if the holders will, in addition to receiving their specified preferential distribution, also participate in the distribution of any remaining amounts, along with the holders of Common Stock. Such a provision is not unusual, but the Company may argue that in a liquidation a preferred investor should be required to either retain the Preferred Stock acquired and get only the specified preferential return, or convert to Common Stock and share in all amounts available for distribution to holders of Common Stock (rather than get the benefits of both a preferred and common position). Sometimes, a series of Preferred Stock will participate in excess distributions above its preferential amount only until a specified cap is reached. Historically, the liquidation amount most typically has been tied to the original purchase price. Now, it is sometimes set as a multiple of the original purchase price. The amount of the liquidation preference may be adjusted depending on how long after the initial investment the liquidating event occurs. If investors ask for too much in terms of a liquidation preference, they may diminish management's incentive to work hard to achieve a liquidation opportunity, as well as make it difficult for the Company to raise additional capital.

¹¹ Other types of transactions to be treated as a liquidation may be identified, such as certain transfers of voting power. By treating mergers and other transactions as liquidation events, the holders of Preferred Stock give themselves the opportunity to obtain liquidity for all or part of their investment (or even a multiple thereof) at a time when holders of Common Stock may not.

The conversion rate will be subject to adjustment, as provided in Antidilution Provisions.¹²

(4) Automatic Conversion: All outstanding shares of Series ___ Preferred will be automatically converted into Common Stock at the then applicable conversion rate, in the event of: (a) a firmly underwritten public offering covering the primary sale of Common Stock at a public offering price per share not less than [_____%] of the original purchase price, with gross proceeds of not less than [_____] (a "Qualified IPO"); or (b) the vote or written consent of holders of at least [two-thirds (2/3)] of the Series ___ Preferred then outstanding.¹³

(5) Antidilution Provisions: The conversion price of the Series A Preferred will be subject to adjustment to reduce dilution in the event the Company issues additional equity securities (other than Reserved Shares, as defined below) at a purchase price less than the applicable conversion price. In such an event, the conversion price shall be adjusted [on a full ratchet basis]¹⁴ [for the first _____ following

¹² Though not described specifically in this memorandum, the conversion rate is typically determined by dividing the original purchase price by a conversion price which usually starts out as being equal to the original purchase price, resulting in an initial one-to-one conversion rate. The anti-dilution protections referenced below are implemented by changing the conversion price, resulting in a revised conversion rate. For instance, if the conversion price were to be dropped to half of the original purchase price, the conversion rate would then be changed to two shares of Common Stock for every share of Preferred Stock converted.

¹³ Automatic conversion serves to enable the Company to cause a simplification of the Company's capitalization structure, at the time of an IPO or other appropriate event. The multiple from the original purchase price used for triggering an automatic conversion in the event of a Qualified IPO is often between 200% to 500%. Investors typically want to be assured of a sufficient return on their investment before they are forced to convert to Common. The total offering size is typically set at a level to indicate it is of sufficient size to generate a true public market and opportunity for liquidity. The Company generally wants to keep the requirements for automatic conversion relatively low, since conversion of all Preferred Stock may be a practical condition precedent to a public offering of the Company's Common Stock. Having an automatic conversion triggered by a vote of the holders is helpful to avoid a situation where the principal holders convert, leaving small holders suddenly wielding unanticipated leverage over the Company, as the remaining holders of an entire class or series of shares, with the accompanying rights and preferences. Such a situation may also be avoided by providing for an automatic conversion of all remaining Preferred Stock of any given series, once less than a certain percentage of the originally issued shares of such series remain outstanding (e.g., less than 25%). Sometimes the minimum requirements for a Qualified IPO will be adjusted, based on when the IPO occurs.

¹⁴ A direct or full ratchet adjustment means that in the event of a dilutive or down round financing, the conversion price of the Preferred Stock enjoying such right will be adjusted downward directly to the issuance price of the newly issued shares, regardless of how many shares are issued at such price. So, the investors having the benefit of full ratchet anti-dilution protection are treated as if they had purchased their shares at the lower price applicable to the later financing. Companies typically negotiate hard to avoid full ratchet anti-dilution provisions, as it can have a draconian result in the event of any dilutive financings. Even many investor groups don't like them (at least when investors other than themselves have such rights), as an investor who refuses to participate to help out a floundering
(continued...)

issuance and thereafter] according to a weighted-average formula.¹⁵ The conversion rate will also be adjusted proportionately for stock splits, dividends, recapitalizations and the like.

[Performance Adjustments: The rate at which shares of Series __ Preferred will be convertible into shares of Common Stock will be adjusted as follows: (i) with respect to the Company's fiscal year ending _____, 20__, if [describe applicable target], the then applicable conversion rate will be _____ by ____; and (ii) with respect to the Company's fiscal year ending _____, 20__, if [describe applicable target], the then applicable conversion rate will be _____.]¹⁶

(6) Voting Rights:

(a) *General Voting*: Holders of Series __ Preferred will have a number of votes equal to the number of shares of Common Stock issuable upon conversion thereof, and will

(...continued)

portfolio Company is benefited as if it did participate in the new financing. As a result, parties dealing with a full ratchet anti-dilution provision will often consider a "pay to play" provision, which will extend the benefit of the full ratchet adjustment on the conversion of Preferred Stock previously acquired only to investors who participate in the dilutive financing that causes the adjustment. Investors are more adamant about obtaining full ratchet protection in times of questionably high corporate valuations. If they believe the Company is being unreasonable in its valuation, they may leave it to the next round investors to negotiate hard on the valuation and price, with the prior round investors then to be treated as if they had invested at that same price. If an investor group is insistent on a full ratchet protection, the Company will typically try to limit it for as short a time period as possible (the idea being that if the Company's valuation doesn't drop within a reasonable time period, the valuation set at the time of the financing is justified), or to have it lapse upon the achievement of specified goals. Alternatively, the parties might build in a "floor," so that once the conversion price drops to that amount (it might be set, for example, at the prior round financing price), the conversion rate adjustment changes to a weighted average formula.

¹⁵ A "weighted average" anti-dilution formula is the most common form of protection against dilution granted to venture investors in "normal" market times, and has a more reasonable impact on the Company's other shareholders (and hence is much preferred by companies over full ratchet adjustments). A weighted average formula takes into account the percentage equity interest of the Company that is issued in a dilutive financing. The formula treats all shares outstanding prior to the dilutive issue as having been issued at a price equal to the conversion price of the Preferred Stock then in effect, and then lowers that conversion price as a result of a new issue to the weighted average of the purchase price of the outstanding and newly issued shares.

¹⁶ Performance or forfeiture provisions are sometimes included as part of a negotiated agreement on the question of valuation. The venture investor may accept a higher initial valuation of the Company if that valuation is subject to downward adjustment (by increasing the conversion rate) if specified performance milestones are not met. These provisions are sometimes structured as mandatory calls, or forfeitures, of Common Stock held by management or the original investors. The Company may want to suggest that if substandard performance subjects the original equity holders to additional dilution or penalties, better than projected performance should entitle them to a corresponding benefit.

have the right to vote on all matters submitted to a vote of holders of Common Stock. Except as otherwise provided herein or required by law, Series __ Preferred [, Series _____ Preferred Stock] and Common Stock will vote together as a single class.¹⁷

(b) *Election of Directors*: Holders of Series __ Preferred, voting as a separate class, will be entitled to elect __ [out of a total of __ directors] [for so long as at least ____% of the shares of Series __ Preferred originally issued remain outstanding]. The remaining ____ directors will be elected by the holders of Common Stock and Series _____ Preferred Stock [voting together as one class]. If at any time the holders of Series __ Preferred lose the right to elect any directors as a separate class, they will vote together with the holders of Common Stock [and Series __ Preferred Stock] on the election of all directors [other than those to be elected by the class vote of any series of Preferred Stock], with the holders of Series __ Preferred voting on an as-converted basis.¹⁸

(7) Protective Provisions:

[(a)] *Shareholder Consent Requirements*: The consent of the holders of at least ____% of the then outstanding shares of Series __ Preferred will be required for any action: (i) amending or repealing any provision of the Company's [Articles] of Incorporation or Bylaws if such action would alter or change the designations, preferences and relative, participating, optional and other special rights of, or the restrictions provided for the benefit of, the Series __ Preferred; (ii) authorizing or issuing shares of any class of stock having any preference or priority as to dividends or assets superior to or on a parity with any such preference or priority of the Series __ Preferred; (iii) declaring or paying any dividend on any junior securities; or (iv) authorizing a

¹⁷ Under the corporate laws of most states, holders of Preferred Stock are generally entitled to vote on significant corporate issues as a class separate and apart from the holders of Common Stock. In venture deals, many of the rights which preferred shareholders would obtain through class voting are granted to them contractually, as provided in the "Protective Provisions" section.

¹⁸ The composition of the Board is often intensely negotiated. An investor group may ask for multiple members on the Board, or at times even a majority. Investors will sometimes provide for their Board representation to increase (to a majority position) in the event the Company fails to meet specified milestones. The parties may provide for two equal factions on the Board representing the preferred investors and other interests, plus an independent outside director acceptable to all parties. Investors unable to secure a position on the Board may ask for the right to receive the information packets distributed to the Board, and to have a non-voting observer attend Board meetings.

merger, sale of substantially all the assets, consolidation, recapitalization or reorganization of the Company.

[(b) *Supermajority Board Consent Requirements*: Certain material business decisions shall require the vote of a supermajority of the Board of Directors [(determined so as to require the approval of the representative[s] of the Series __ Preferred Stock)]. Such items shall include: incurrence of substantial debt; disposal of substantial assets; change of business; establishment of, and variance from, standard stock vesting provisions for employees; and repurchases of shares of capital stock, except for repurchases at cost under employee incentive plans.]¹⁹

8. [Redemption Rights:]

[(a) *At Election of the Company*: Upon proper notice to the holders of Series __ Preferred, the Company shall be entitled to redeem all or any part of the Series __ Preferred by paying a redemption price of [__%] of the original purchase price per share, plus any accrued or declared but unpaid dividends, at any time after the ____ anniversary of the original issuance of the Series __ Preferred.]

[(b) *At Election of Holders*: Each holder of Series __ Preferred may elect [or this may be tied to an election being made by a specified percentage of the holders of the Series __ Preferred] to require the Company to redeem shares of Series __ Preferred held, in accordance with the following Schedule, at a redemption price equal to ____% of the original purchase price per share, plus any accrued or declared, but unpaid, dividends: (i) [fifth] anniversary of original issuance date – 1/3 of the outstanding shares; (ii) [sixth] anniversary of the original issuance date – 50% of the then outstanding shares; (iii) [seventh] anniversary of

¹⁹ The list of transactions requiring special shareholder or board approval will vary depending on the circumstances of the issuer. Whether an item is subject to special Board approval or shareholder approval will also depend on the investors' comfort level. Keeping approval and/or veto rights in the hands of the directors may simplify the approval process, but may raise fiduciary concerns where directors vote based on what is best for the investors they represent rather than what may be best for the Company and shareholders as a whole. Also, if protective provisions are granted at a Board level, if business developments cause directors to consider resigning their fiduciary positions, the investors represented by the resigning directors would lose their ability to exercise their protective rights. Shareholders are generally free to vote according to what they believe to be in their own best interests, rather than what may be in the best interests of the Company or shareholders as a whole.

the original issuance date – 100% of the then outstanding shares.]²⁰

Stock Purchase Agreement:

The purchase of Series __ Preferred, if consummated, will be made pursuant to a Series __ Preferred Stock Purchase Agreement reasonably acceptable to the Company and the Investors (the “Stock Purchase Agreement”). The Stock Purchase Agreement will contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein, indemnification provisions with respect to such representations, warranties and covenants, and appropriate conditions of closing [which will include, among other things, compliance with applicable laws, performance of the covenants and agreements referenced herein, the filing of amendments to the Company’s [Articles] of Incorporation creating the Series __ Preferred, [satisfactory completion of the Investors’ due diligence review] and opinions of counsel].²¹

Stock Restriction Agreements:

The shares of Common Stock owned by [the founders] [other employees?] are or will be subject to stock purchase or restriction agreements providing for purchase options in favor of the Company at a price per share equivalent to the price per share paid for the stock and with vesting at the rate of [one-quarter] of such shares at the end of the first year after the date of purchase and thereafter [quarterly] vesting in equal increments over a [three year] period. In

²⁰ Preferred Stock may be redeemable, either at the option of the Company or the investors, or mandatorily on a certain date, perhaps at some premium over the initial purchase price of the shares. A primary goal of venture investors is to ensure the eventual liquidity of their investment. Puts or redemption features provide this liquidity more directly than any other mechanism. However, a put can place a tremendous burden on growing companies, which may not have the immediate ability to refinance their capital structure in order to accommodate a put. The Company will typically resist a put, on the theory that the expected liquidity will be achieved when the Company goes public or is acquired. The investors may insist on a put to give them leverage in discussions, or force the Company to cash them out at some point (assuming funds are available), if the other liquidity options have not materialized. Features of a put may include payment terms and differing payment amounts, tied to the liquidation or market values of the shares. The consequence of the Company’s inability to redeem the preferred shares following the exercise of a put is an important issue to be addressed. The investors will typically require a corresponding decrease in the conversion price of their preferred shares, a chance in control of the Company’s Board, or some other penalty. Redemption rights give the investors holding such rights with negotiating leverage, but are seldom exercised and can make an investment look more like debt than equity. Such rights are generally renegotiated or eliminated as new investors come on board, or the new investors will typically insist on comparable redemption rights.

²¹ The memorandum will sometimes specify whose counsel will prepare the initial draft of the Stock Purchase Agreement. Although some venture capital firms and angel groups still require legal opinions, the trend is to not require them. This is particularly true in smaller financings.

each case, the Company's purchase option is exercisable upon the termination, death or disability of the founder thereunder. [Vesting will accelerate in the event of a sale of the Company][, but only if the shareholder's employment is terminated, without cause, within [12] months following such transaction.]²²

Investor Rights and Shareholder Agreement:

Concurrent with the execution of the Stock Purchase Agreement, and as a condition to the closing, _____, _____ and _____ (the "Subject Shareholders") will enter into an Investor Rights and Shareholder Agreement with the Company and the Investors (the "Shareholder Agreement"). This Shareholder Agreement will provide the following rights and covenants of the parties:

(1) Registration Rights of Investors:

(a) *Demand Rights:* [At any time after the earlier of an initial public offering of the Company's Common Stock or the [third] anniversary of the original issuance of the Series __ Preferred,] Investors holding at least [40%] of the Series __ Preferred (or Common Stock issued upon conversion of the Series __ Preferred or a combination of such Common Stock and Series __ Preferred) then outstanding but not registered may require that the Company use its best efforts to cause shares specified by such Investors to be registered [, provided that the aggregate proceeds from such shares to be registered is expected to exceed \$ _____.] [The Company will be required to effect no more than [two] such registration[s].]²³

²² The imposition of vesting and repurchase requirements on existing shareholders of early stage companies can be a significant business issue. Investors will want to make sure key employees are committed and incentivised to remain with the Company, and to provide a mechanism to free up shares for allocation to replacement employees, if required, without diluting the investors. Founders and shareholders who believe they have already paid or contributed the cash, services or other consideration entitling them to their shares will resist the imposition of vesting and repurchase requirements. Compromises often center around the portion of the employees' equity that becomes subject to restriction, and the duration of those restrictions. Vesting may accelerate upon various circumstances, such as a sale of the Company. Investors will sometimes want to add a second "trigger" for accelerated vesting, such as termination without cause within a specified time following the initial triggering event.

²³ The Company may provide that it will not be obligated to effect a demand registration if the investors can effect a sale under SEC Rule 144 or 144A. Note that publicly registering the Company's securities is extremely expensive and time-consuming. Accordingly, the Company will try to limit or postpone the ability of the investors to force the Company to register its shares, particularly if the registration will be an IPO. The Company may also negotiate to limit the circumstances under which the Company will pay the registration expenses and the times when the investors can make a registration demand.

(b) *Company Registrations*: The holders of Series ___ Preferred will be entitled to “piggyback” registration rights on registrations of the Company [after an initial public offering], subject to the right of the underwriters to reduce the number of shares proposed to be registered by the Investors in view of market conditions] [provided that in no event will the shares to be sold by the Investors be reduced below [20%] of the total amount of securities included in the registration.] [No shares of Common Stock will be granted piggyback registration rights which would reduce the number of shares includable by the Investors in such registration, without the consent of holders of at least [2/3] of the unregistered shares of Common Stock issued or issuable on conversion of the Series ___ Preferred.]²⁴

(c) *S-3 Rights*. The Investors will be entitled to unlimited demand registration rights on Form S-3 (if available to the Company) so long as such registered offerings are not less than [\$500,000].

(d) *Registration Expenses*: The Company will bear all expenses (exclusive of underwriting discounts and commissions and fees of more than one counsel for all selling shareholders) of all registrations.

(e) *Other Registration Provisions*: Other provisions will be contained in the Investor Rights Agreement with respect to registration rights as are reasonable and customary, including cross-indemnification, the period of time in which the Registration Statement is to be kept effective, underwriting arrangements, the transfer of registration rights to transferees of the Series ___ Preferred and the Common Stock issued on conversion thereof, and the like.

(2) *Information Rights*: So long as an Investor holds at least _____ shares of Series ___ Preferred [or Common Stock issued upon conversion thereof], the Company will furnish the Investor with unaudited [monthly][quarterly] financial statements, annual financial statements audited by an accounting firm of national reputation, and an annual

²⁴ The terms upon which any cutbacks required by an underwriter will be implemented is often negotiated, as well as the Company’s ability to grant other registration rights which may impair the investors’ ability to effectively exercise their rights in full.

budget; provided, however, that these obligations will terminate upon a public offering of Common Stock.²⁵

(3) Investor Right of First Refusal: So long as an Investor is a holder of [_____ shares of] Series __ Preferred or Common Stock, if the Company proposes to offer any shares (other than the Reserved Shares, shares issued in the acquisition of another company, or shares offered to the public pursuant to an underwritten public offering), the Company will first offer to such Investor the right to participate in such offering of shares on a pro rata basis, in accordance with such Investor's proportional equity interest in the Company.

(4) Reserved Shares: The Reserved Shares will be: (i) _____ shares which may be issued from time to time under the Company's equity incentive plans to employees, consultants, directors or officers; (ii) shares issued on conversion or exercise of options, warrants, Preferred Stock or other securities outstanding on the date hereof; and (iii) with respect to the Right of First Refusal, shares issued on conversion or exercise of options, warrants, Preferred Stock or other securities issued in compliance with such Right of First Refusal.²⁶

(5) Right of First Refusal on Shareholder Sales. The Company will be granted a right of first refusal, and the Investors will be granted a right of first refusal subordinate to the right of the Company, in the event of any proposed sale of any shares of Common Stock held by the Subject Shareholders.

(6) Co-Sale Rights. Shares not purchased by the Company or the Investors under the right of first refusal referenced in the preceding paragraph will be subject to a right of the Investors to sell side-by-side on a pro rata basis (in the nature of a co-sale or tag-along right). Such rights will terminate on an IPO or acquisition of the Company.

²⁵ Sometimes an annual operating plan or other document will be requested. Additional visitation and inspection rights may also be requested. Often, annual financial statements will be made available to all holders, while other information will be made available only to those holding a specified number or percentage of shares.

²⁶ What share issuances will not be trigger an anti-dilution adjustment is an important negotiation. Typically, 10%-20% of the Company's capital stock will be reserved for issuance to employees and those shares will be excluded from the anti-dilution adjustment. Other types of exclusions a Company may pursue include issuances as consideration for acquisitions, stock issued in connection with contracting for strategic alliances, and stock issued as currency for supplies, licenses and rent.

(7) Exempt Transfers. Notwithstanding the above restrictions, each Subject Shareholder will be able to sell up to an aggregate of _____ shares of Common Stock free of the restrictions of such Shareholder Agreement. In addition, the Shareholder Agreement will exempt transfers to spouses, issue or trusts for the benefit of the Subject Shareholders or their respective spouses and/or issue, assuming such transferees agree to be bound by these restrictions.

Other Covenants and Agreements:

Key Person Insurance: As a condition to closing, the Company shall take out [\$1,000,000] of renewable term life insurance on the life of _____, [CEO] of the Company, naming the Company as beneficiary.

Board of Directors: Upon the closing of the financing, the Board of Directors shall be composed of the following individuals:
 _____, a representative of _____ [and
 _____, a representative of _____] as
 the director[s] elected by the holders of Series __ Preferred,
 and _____ [and]
 _____ [and _____], as the
 directors elected by a vote of the holders of Common Stock
 [and Series __ Preferred Stock]. [Each Investor or group
 of affiliated Investors holding at least _____ shares of
 Series __ Preferred, or Common Stock issued upon
 conversion thereof, shall have a right of access to meetings
 of the Board.] [Each director representing the Series __
 Preferred shall be entitled to have expenses incurred in
 attending Board meetings paid by the Company.]

[Warrant Coverage:] [Each Investor shall receive a warrant exercisable for a period of ___ years for the purchase of a number of shares of Common Stock equal to ___% of the number of shares of Series __ Preferred Purchased. The exercise price will be \$ ___ per share. The warrants will automatically expire, if not previously exercised, upon a Qualified IPO.]²⁷

²⁷ In today's environment, many investors seek warrant coverage. Typically, these warrants will have an exercise price at a discount from the original purchase price of the Preferred Stock and will entitle the investor to purchase shares of Common Stock in an amount tied to the amount invested.

[Finders]

[The Company and the Investors shall each indemnify the other for any finder's fees for which either is responsible.]

[Other possible covenants]

[Other potential covenants, agreements and conditions to closing may include: employment agreements with key employees; execution of agreements regarding confidentiality, assignment of inventions and non-competition; voting agreements; agreement regarding standard stock vesting arrangements; satisfactory completion of due diligence; and establishment of an agreed upon pool for employee equity incentives.]

Transaction Expenses:

The Company and the Purchasers will each bear their own legal and other expenses with respect to the transaction, except that if the transaction closes, the Company will pay not more than \$ _____ of legal fees incurred by [a single] legal counsel to the Investors).²⁸

[You may on some transactions desire to establish an exclusivity provision, to restrict the Company from soliciting alternative financing proposals from others. In such circumstances, you would probably want to make such a provision binding, and so should modify the language in the introductory paragraph of the memorandum to clarify that this provision is binding. You would also want to provide for the parties to execute the memorandum. A provision dealing with this issue might read something like the following: "Upon execution hereof and until _____, 20__, or such earlier date on which the Investors inform the Company that they are no longer interested in financing the Company as described above, the Company will not initiate, respond to, or participate in any way, in any discussions regarding, or accept, any proposal for, alternative equity financing arrangements."]

²⁸ Investors may resist the ceiling on fees payable at the closing, or try to put in an excessively high ceiling. Occasionally, a potential Lead Investor will enter into a separate fee agreement with the issuer, in which the issuer makes a binding commitment to reimburse the legal fees and out-of-pocket expenses incurred by such Lead Investor in investigating and negotiating the proposed investment, whether or not the financing ever closes.