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*Carlton Fields practices law in California through Carlton Fields Jorden Burt, LLP*



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**TERM SHEET**[[1]](#footnote-1)

**[Series B Preferred Stock]**

**Proposed Private Placement Investment of**

**Series B Convertible Preferred Stock**[[2]](#footnote-2) **of**

**[Insert Name of Issuing Corporation]**

The following is a summary of the principal terms with respect to a proposed sale of Series B Convertible Preferred Stock of *[Insert Name of the Issuing Corporation]* to *[Insert Name of Investor or Investment Group]* (the "Transaction"). Except as set forth below, this is a non-binding Term Sheet setting forth a summary of the proposed terms of the Transaction and is intended solely as a basis for further discussions and is not intended to be, and does not constitute, a legally binding obligation of any party. A legally binding obligation will be established only pursuant to mutually acceptable definitive written agreements[[3]](#footnote-3) executed by the parties. In the event of any inconsistency between this summary and such definitive written agreements, the definitive written agreements will govern.

|  |  |
| --- | --- |
| **Issuer:** | *[Insert Name of the Issuing Corporation]*, a [Insert State of Incorporation] corporation (the "Company"). |
|  |  |
| **Purchasers:** | *[Insert name of Investors and Investor Groups]* and/or their affiliated investment vehicles (“Investor Group”) and other permitted investors (the "Other Investors"). |
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| **Investment Amount:** | Up to $\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_.[[4]](#footnote-4) |
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| **Securities:** | \_\_\_ shares of Series B Convertible Preferred Stock (the "Series B Preferred Stock"), representing *[to be determined]* % of the outstanding securities of the Company on a fully-diluted basis as of the closing of the Transaction (the “Closing”).[[5]](#footnote-5) |
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| **Valuation/Purchase Price:** | The purchase price of the Series B Preferred Stock will be calculated based on a fully diluted pre-money valuation of the Company of $[*insert valuation*] (at a purchase price of $\_\_\_\_ per share), based on the assumption of \_\_\_\_\_\_\_\_ shares outstanding on a fully diluted basis[[6]](#footnote-6) [after pre-investment expansion of the management option pool set forth below][[7]](#footnote-7) such that the purchase price shall be $[*insert price per share*] per share of Series B Preferred Stock (the "Purchase Price"). |
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| **Post Transaction Capitalization:** | The Company’s post-Transaction capitalization shall be as set forth in Appendix I hereto.[[8]](#footnote-8) |
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| **Use of Proceeds:** | The proceeds from the Transaction shall be used *[insert specific uses for the proceeds from the sale of Series B Preferred Stock, such as payment for the professional fees associated with the Transaction, investment in the infrastructure for the expansion of the business, hiring additional management and sales personnel, achieving any required milestones, and general working capital purposes]*. |
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| **Ranking:** | At the Closing, the Series B Preferred Stock shall rank senior to any of the Company's Preferred Stock issued prior to the Transaction (“Junior Preferred Stock”) and the Company’s common stock, par value $\_\_\_ per share (“Common Stock”), with respect to dividends, liquidation, dissolution, certain voting rights, *[and redemption rights]*. |
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| **Dividend Rights:** | Dividends will accrue on the Series B Preferred Stock at a rate of \_\_\_% per annum, payable whenever funds are legally available and when and as declared by the Company's Board of Directors. Such dividends shall be cumulative and compound annually. Dividends accrued and payable on the Series B Preferred Stock will be paid in preference to any dividends accrued or payable on the Junior Preferred Stock and Common Stock.[[9]](#footnote-9) |
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| **Liquidation Preference:** | In the event of Liquidity Event (defined below), each holder of Series B Preferred Stock will be entitled to receive, in preference to the holders of the Junior Preferred Stock and Common Stock, an amount equal to [twice][[10]](#footnote-10) the Purchase Price plus any accrued but unpaid dividends thereon (the "Liquidation Amount"). After the entire Liquidation Amount of the Series B Preferred Stock has been paid, holders of the Junior Preferred Stock will then be able receive any funds to which such holders are entitled in preference to the holders of the Common Stock. Following the payment of the Liquidation Amount to the holders of the Series B Preferred Stock [and the preference payments to the holders of the Junior Preferred Stock], any remaining funds and assets of the Company will then be distributed *pro rata* among the holders of the Series B Preferred Stock, the Junior Preferred Stock and Common Stock on an as-converted basis.[[11]](#footnote-11)  For purposes of this Term Sheet, the term “Liquidity Event”[[12]](#footnote-12) shall mean any of the following: (a) any liquidation, dissolution or winding-up of the Company, (b) a merger, reorganization, consolidation, or other change of control transaction (including, without limitation, any sale or share exchange transaction) where the shareholders of the Company immediately prior to such transaction will not retain [a majority][at least \_\_%] of the voting power in the Company or the surviving corporation, as the case may be, on a fully diluted basis, or (c) a sale of all or substantially all the Company's assets. |
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| **Permissive Conversion:** | The shares of Series B Preferred Stock will be convertible, at any time at the option of the holder, into shares of Common Stock on a one-to-one basis, subject to the anti-dilution provisions described below. |
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| **Automatic Conversion:** | The Series B Preferred Stock shall be automatically converted into Common Stock, at the then-applicable conversion rate, upon the closing of a firm commitment underwritten public offering of the Common Stock in which the Company receives [at least $10 million in net proceeds (after payment underwriter’s commissions and expenses) and the offering price is not less than \_\_\_% of the conversion price of the Series B Preferred Stock] (a “Qualified IPO”).[[13]](#footnote-13) |
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| **Redemption:**[[14]](#footnote-14) | If a Liquidity Event or a Qualified IPO has not occurred prior to the earlier of (a) the [fifth][[15]](#footnote-15) anniversary of the Closing of the Transaction, or (b) a material default under any of the documentations entered into in connection with the Transaction, the holders of [a majority of][[16]](#footnote-16) the Series B Preferred Stock shall have the right to require the Company to purchase or redeem the Series B Preferred Stock. The redemption price of the Series B Preferred Stock shall be an amount equal to the greater of: (i) the fair market value of the shares of Series B Preferred Stock determined by the amount that a holder would receive in a Liquidation Event, if the holder thereof converted its Series B Preferred Stock immediately prior to such Liquidation Event, or (ii) the Liquidation Amount. The fair market value shall be determined either (x) the mutual agreement of the holders of a majority of the Series B Preferred Stock and the Company or (y) a mutually acceptable and independent financial expert. The redemption price shall be paid in cash.  [To the extent that the Company’s available cash assets are insufficient to pay the redemption price to the holders of the Series B Preferred Stock, the holders of the Series B Preferred Stock shall [have the option to] accept a promissory note for the remainder of the amount due, which promissory note shall be for a period of [one] year, bearing interest at a rate of [prime plus \_\_%] per annum, compounded quarterly, [and the holders of a majority of the shares of Series B Preferred Stock shall be entitled to elect a majority of the board of directors of the Company until such amounts are paid in full].[[17]](#footnote-17) |
| **Anti-Dilution:** | The conversion price of the Series B Preferred Stock will be subject to [adjustment on a full ratchet basis to prevent dilution][adjustment to prevent dilution on a “weighted average basis][[18]](#footnote-18) if the Company issues additional shares of its Common Stock at a purchase price less than the Preferred Stock's then current conversion price, subject to certain mutually agreed upon exceptions.  Among other things, the following issuances shall be excluded from these anti-dilution provisions: (a) shares of Common Stock reserved for employees pursuant to an employee incentive plan approved under the Terms of this Transaction or approved by a majority of the directors elected to the board by the holders of the Series B Preferred Stock (“Preferred Directors”), (b) issuance of stock under options, warrants, convertible securities[[19]](#footnote-19) or other rights issued and outstanding prior to the Transaction, (c) Common Stock issued in connection with stock dividends, stock splits, and similar events,[[20]](#footnote-20) and (d) [shares of Common Stock issued in connection with acquisitions, bank financings and lines of credit, equipment leasing, and other strategic transactions [approved by \_\_% of the board of directors]. |
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| **Adjustments Upon Recapitalizations:** | In the event of any stock dividends, stock splits, subdivisions, combinations, or similar events, an adjustment will be made such the holders of the Series B Preferred Stock will hold the same relative ownership position (including, on an “as converted basis”) after such action as they had immediately prior to such action. |
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| **Voting Rights:** | Each share of Series B Preferred Stock shall have the right to vote on an “as converted basis” (including fractions) and shall vote together with the Common Stock and not as a separate class, except as specifically provided herein or as otherwise required by law. |
|  |  |
| **Preemptive Rights:** [[21]](#footnote-21) | If the Company proposes to issue any new equity securities (or securities convertible, exchangeable, or exercisable into any equity securities of the Company), the holders of the Series B Preferred Stock [holding at least \_\_\_ shares] shall have the right to purchase their *pro rata* share of the issuance so that they may maintain their percentage ownership (on a Common Stock equivalent basis) on a fully diluted basis. These preemptive rights will not apply to shares (a) reserved for issuance or granted under a stock option or other employee incentive program approved by the board of directors, (b) options, warrants, convertible securities or other rights issued and outstanding prior to or pursuant to the Transaction, or (c) shares issued in connection with stock dividends, stock splits, and similar events. The preemptive rights will terminate upon the occurrence of a Liquidity Event or a Qualified IPO. |
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| **Right of First Refusal:** | The Company shall have the right of first refusal to purchase any securities offered for sale by the founders, management, or other holders of Common Stock or Junior Preferred Stock pursuant to which there exists a bona fide offer to purchase.[[22]](#footnote-22) To the extent that the Company does not exercise its right of first refusal, each member of the Investor Group shall then have a right of first refusal to purchase the remaining shares. This right will terminate upon the occurrence of a Liquidity Event or a Qualified IPO. |
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| **Co-Sale Rights:** | The Investor Group or its designees will have the right to participate, on a *pro rata* as converted basis, in the sale of any stock of the Company by any shareholder [owning 5% or more of the Company’s voting securities]. |
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| **Drag Along Rights:** | [So long as the Investor Group owns shares of Series B Preferred Stock representing at least [\_\_\_%] of the Company’s Common Stock on a fully-diluted basis], the Investor Group shall have the right to require all other holders of capital stock of the Company to approve and to engage in a proposed sale of the Company to an unrelated third party (whether structured as a merger, reorganization, asset sale or otherwise).[[23]](#footnote-23) |
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| **Registration Rights:**[[24]](#footnote-24) | Holders of the Series B Preferred Stock and any shares of Common Stock issued upon conversion of the Series B Preferred Stock (the “Registrable Securities”), may require[[25]](#footnote-25), by request of [50]% of the Registrable Securities (calculated as if all shares of Series B Preferred Stock has been converted into Common Stock), on not more than [(3) three] occasions following the earlier of[[26]](#footnote-26): (a) ninety (90) days after the closing of the company’s initial public offering, and (b) two-year anniversary date of the Closing, the Company to use its best efforts to file a long-form registration statement covering a public sale of the [Registrable Securities][[27]](#footnote-27) having an aggregate gross public offering price of at least [$10,000,000].[[28]](#footnote-28)  Holders of Series B Preferred Stock will have unlimited piggyback[[29]](#footnote-29) and Form S-3, when available, registration rights.[[30]](#footnote-30) All such registrations shall be at the expense of the Company, except that underwriting commissions will be borne *pro rata* by the holders of the shares included in the registration statement. |
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| **Right of First Offer: [[31]](#footnote-31)** | If holders of the Series B Preferred Stock desire to transfer any or all of their shares, such holders shall so advise the Company and give the Company the right to make an offer to purchase such shares and such holders can either accept the Company’s offer or seek other purchasers at a price no less than that offered by the Company. |
| **Protective Provisions:**[[32]](#footnote-32) | The Company shall not take any of the following actions without the affirmative vote of [two-thirds] of the outstanding shares of the Series B Preferred Stock: (a) any authorization or issuance of any securities senior to or on a parity with the Preferred Stock, (b) any amendment to the Articles [Certificate] of Incorporation of Bylaws of the Company, that [(i) alters or changes the rights, preferences, or privileges of the Series B Preferred Stock or increases the number of authorized shares of Series B Preferred Stock, (ii) increases or decreases the authorized number shares of the Company’s capital stock, (iii) creates (by reclassification or otherwise) any new class or series of shares of capital stock having rights, preferences, or privileges senior to or on a parity with the Series B Preferred Stock,] (c) the repurchase or redemption of any shares of Common Stock, Junior Preferred Stock or other capital stock of the Company, (d) the payment of dividends on or other distributions with respect to any shares of Common Stock, Junior Preferred Stock, or other equity or interests in the Company, (e) the amendment or waiver of any covenants and other deal-specific class voting provisions of any provisions of the Articles [Certificate] of Incorporation or Bylaws of the Company, (f) incurrence of any indebtedness, liens, and other contingent obligations in excess of [$\_\_\_\_\_\_][\_\_\_\_% of \_\_\_\_], including any guarantees[, except as may be approved by the majority of the then-sitting Series B Preferred Directors], (g) material acquisitions of another business entity or a division thereof in excess of $\_\_\_\_\_ [, except as may be approved by the majority of the then-sitting Series B Preferred Directors],(h) an increase or a decrease in the size of the Company’s board of directors, and (i) entering into any agreement with respect to, or engage in, any merger, consolidation, corporate reorganization, share exchange, transaction or series of transactions in which more than 50% of the voting power of the Company is sold or otherwise transferred, or any voluntary dissolution, liquidation or winding-up, or the sale (including sale-leasebacks) or exclusive license of all or substantially all of the Company’s assets or its intellectual property in any one or a series or related transactions. |
| **Board Representation:** | The Company’s corporate governance documents shall be amended to provide that [for so long as at least \_\_\_ shares of Series B Preferred Stock remain outstanding]: (a) the size of the board of directors of the Company shall be fixed at \_\_\_\_\_\_ directors, and (b) that the holders of the Series B Preferred Stock shall have the right to elect \_\_\_\_\_ of directors to serve as Series B Preferred Director(s). the Stockholders Agreement (described below) shall ensure that the person(s) designated by the Investor Group to serve as the Series B Preferred Director(s) will be elected. The remaining directors shall be elected by the holders of the Preferred Stock and the Common Stock voting together as a class (with the Preferred Stock having that number of votes equal to the number of shares of Common Stock then-issuable upon conversion of such Preferred Stock)[[33]](#footnote-33). This right will terminate upon the occurrence of an initial public offering of the Company’s securities registered under the Securities Act. |
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| **Board Approvals:** [[34]](#footnote-34) | Approval of a majority of the Board of Directors [including a majority of the Series B Preferred Directors] shall be required as a condition to any of the following actions being taken by the Company: (a) hiring [or firing] of a [CEO][CFO][executive officers] of the Company, (b) adoption of any new equity incentive award program or arrangement or granting equity awards to officers or employees under any Company equity incentive plans (whether pre-exiting or newly approved), (c) enter into related party transactions with existing employees, executive officers, and equity holders, or their respective affiliates, other than payment of customary salary for services rendered or other employee befits generally made available to all employees, (d) change the primary line of business of the Company or make any other fundamental change in the Company’s business plan, (e) enter into or amend any contract involving payments in excess of $\_\_\_\_\_ or make any capital expenditures in excess of $\_\_\_\_\_, unless already approved by the Board as part of the Company’s annual budget, and (f) incur indebtedness in excess of $\_\_\_\_\_ which is not specifically reflected in the Company’s annual capital and operating budget previously approved by the Board. |
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| **Events of Non-Compliance:**[[35]](#footnote-35) | An “Event of Non-Compliance” shall exist if any of the following shall occur: (a) a failure make any redemption payment on the Series B Preferred, (b) the Company’s breach of any of the covenants or fails to comply with the provisions of the Stock Purchase Agreement or any of the other Transaction Documents, (c) any material breach or inaccuracy of the representations or warranties of the Company as of the Closing, (d) the Company should become insolvent, bankrupt, or is placed into receivership, (e) any [unsatisfied] judgment is levied against the Company in excess of $\_\_\_\_\_\_\_\_\_\_, or[(e) a default by the Company under any agreement for indebtedness for borrowed money exceeding $\_\_\_\_\_\_ causing acceleration of the amount due thereunder or under any material agreement with a third party].  Upon an Event of Non-Compliance, [(i) the dividends on the Series B Preferred will increase by [two] percent ([2])% [for each ninety-day period of noncompliance, up to a maximum of [twelve] percent ([12])%], (ii) holders of a [majority] of the then-outstanding Series B Preferred shall have the right to demand the immediate redemption of all or a portion of the outstanding Series B Preferred, and (iii)] the Investor Group will be entitled to appoint such additional Preferred Directors to the Board such that they will have a majority of the directors of the Board. Such remedy[ies] shall remain in place until such time as the Event of Non-Compliance has been cured (or the Series B Preferred has been redeemed in full). |
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| **Information Requirements:** | For so long as at least [5]% of the Series B Preferred Stock issued pursuant to the Transaction remains outstanding, the Company shall deliver to the Investor Group: (a) unaudited monthly and quarterly financial reports, (b) audited annual financial statements, (c) at least 60 days in advance of each fiscal year, a comprehensive annual operating budget and the monthly forecast of the Company’s revenues, expenses, and cash position for the year, (d) prior to the start of each quarterly period, the quarterly operating budget and the monthly forecast of the Company’s revenues, expenses, and cash position for the quarter, and (e) prompt notice of any material litigation or defaults under any material agreements. The Company also shall provide the Investor Group with such other financial information reasonably requested them. These rights will terminate upon the occurrence of [an initial public offering of the Company’s equity securities][a Qualified IPO].[[36]](#footnote-36) |
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| **Transaction Documents:** | The investment in the Series B Preferred Stock shall be made by the Investor Group pursuant to a Stock Purchase Agreement and other related documents, to be prepared by legal counsel to the Investor Group, reasonable acceptable to the Company and the Investor Group, which agreements shall contain, among other things, appropriate representations, warranties and covenants of the Company and its shareholders reflecting the provisions set forth herein, and appropriate conditions to closing [and a customary opinion of counsel to the Company]. It is anticipated that such documentation will include, among other things, amended and restated Articles of Incorporation [Certificate of Designations] and Bylaws, and a stockholders’ agreement or similar agreements (all such documents, together with the Stock Purchase Agreement, collectively, the “Transaction Documents”). For so long as at least [10]% of the shares of Series B Preferred Stock issued pursuant to the Transaction remain outstanding, the consent of a majority of the holders of the Series B Preferred Stock will be required for any amendment to the Transaction Documents or any waiver of covenants (other than at the Articles of Amendment [Certificate of Designations] which shall be governed by the provisions contained therein). |
|  |  |
| **Non-Compete Agreements:** [[37]](#footnote-37) | All executive officers and certain designated employees shall enter into an acceptable proprietary information and inventions agreement and assignment, as well as an acceptable non-compete and non-solicitation agreement for a period of [\_\_] year(s) after leaving the Company. |
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| **Conditions Precedent:** | This Transaction is subject to: (a) the completion of the Transaction Documents acceptable to the Investor Group, (b) the completion of due diligence acceptable to the Investors Group, (c) the accuracy of the representations and warranties of, and compliance with the covenants by, the Company, and (iv) the approval of the Investor Groups’ investment committees.[[38]](#footnote-38) |
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| **Expenses:** | Upon the closing of the Transaction or in the event that the Company elects not to close this Transaction, the Company will pay the Investor Group’s reasonable and documented out-of-pocket expenses related to its due diligence investigation and this Transaction, including all closing costs, reasonable legal fees and due diligence expenses up to maximum of $\_\_\_\_\_\_\_\_. |
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| **Exclusivity:** | Until the earlier of \_\_\_\_\_ or the Closing, neither the Company, nor any of its officers, directors, employees, agents, or affiliates will seek, offer to sell, enter into any discussion or negotiations or otherwise enter into any transaction with respect to the capital of the Company without the prior written consent of the Investor Group. |
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| **Closing Date:** | The Closing will occur on or before \_\_\_\_\_\_\_\_\_\_\_, or such other time agreed to by the parties. |
|  |  |
| **Governing Law:** | [insert state][[39]](#footnote-39) |
|  |  |
| **Binding Provisions:** | With the exception of those sections of this Term Sheet relating to Expenses, Exclusivity, Governing Law, Conditions Precedent, Expiration, and Binding Provisions, this Term Sheet is a non-binding document prepared for discussion purposes only. |
|  |  |
| **Expiration:** | This Term Sheet will expire unless signed by the Company and returned to the Investor Group on or before \_\_\_\_\_\_\_\_\_\_\_. |

**[Signatures on Next Page]**

AGREED AND ACCEPTED AS OF THE DATE ABOVE**INVESTOR GROUP**

**[Name of Investor Group]**

By:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_Name: Title:  **THE COMPANY[Name of the Company]**, Inc

.By:\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_Name: Title: President

[Signature page to Term Sheet, Dated \_\_\_]

1. This sample Term Sheet is for use in a second or third round financing with a venture capital or private equity fund. It is not for use with a friends and family offering or angel investor financing. Although the entity could be a limited liability company, a limited partnership, a corporation, or other entity, the proposed investment reflected in this Term Sheet is a preferred stock purchase from a corporation where the preferred stock will be senior to any existing equity securities and will have priority rights to any cash distributions (dividends, redemptions, etc.), to a return on investment, and to authorize, approve or disapprove of various corporate transactions that may adversely affect the preferred stock investment. [↑](#footnote-ref-1)
2. If this is third or later round of private financing, the Series of Preferred Stock may be a Series C or later. In almost all cases, the Preferred Stock is convertible into common stock of the Company. [↑](#footnote-ref-2)
3. Generally, the definitive agreements consist of: (a) a Securities Purchase Agreement (providing for the purchase of the Series B Preferred Stock), (b) amended Articles of Incorporation or Certificate of Designation (depending on the state of incorporation) setting forth the designations, preferences, voting powers, relative, participating, optional or other special rights and privileges, and the qualifications, limitations and restrictions of the Series B Preferred Stock, (c) a Registration Rights Agreement (described below), (d) a Stockholders Agreement establishing the relationship between the holders of the Series B Preferred Stock and the other securities holders of the Company, such as voting agreements, rights to designate directors to serve on the board of directors, rights of first refusal for transfers of shares, requirement for special approvals from holders of the Series B Preferred Stock in order to take certain corporate actions that are not contained in the amended Articles of Incorporation or the Certificate of Designations, etc., and rights to certain information and reports from the Company on a periodic basis. In some instances, the various agreements contained in a Stockholders Agreement may be included in a number of separate documents instead of in one comprehensive document. [↑](#footnote-ref-3)
4. The amount invested could be subject to reduction for a number of reasons, such as a reduced valuation of the Company during due diligence or the inability to secure additional investors if necessary to fund the full investment amount (and in the case of the latter situation, the closing of a lesser amount should be subject to the Company’s approval). Furthermore, the full amount of the investment could be broken in to various tranches whereby subsequent investment amounts are made or released subject to timely achievement of certain milestones set forth in both the Term Sheet and the definitive investment documents. [↑](#footnote-ref-4)
5. Occasionally, the Investor Group also may seek to receive warrants to purchase addition shares of Series B Preferred Stock equal to a certain percentage of their investment at an exercise price equal to the Purchase Price (with cashless exercise rights). In essence, the Investor Group is seeking an additional upside for their investment without committing additional cash to the Company until they are ready to cash out. It creates dilution for future investors while locking in the price for the Investor Group. [↑](#footnote-ref-5)
6. This includes all shares reserved for issuance upon exercise of outstanding stock options and other rights to purchase shares of the Company. [↑](#footnote-ref-6)
7. It is not uncommon for the Investor Group and the Company to agree to set aside a specific number or percentage of Common Stock for issuance to management and key employees under an employee equity incentive plan. If such a provision is included, it would specify the number or percentage of shares in the plan, restrict post-closing changes to the plan, and include a right to repurchase any shares issued under the plan if the executive should be terminated or resign. This Term Sheet does not include such a provision. [↑](#footnote-ref-7)
8. This provides the Investor Group with a full understanding of the pre-Transaction capitalization and the Company with a full understanding of the post-Transaction capitalization, including any shares reserved for issuance under any employee equity incentive plan. [↑](#footnote-ref-8)
9. Sometimes the Investor Group will seek to prohibit the payment of dividends on any junior securities (e.g., common stock and pre-existing Preferred Stock) so long as the Series B Preferred Stock remains outstanding. [↑](#footnote-ref-9)
10. This is a heavily negotiated term. The Investor Group will seek to obtain their preferred rate of return before permitting other equity holders to receive any proceeds from a Liquidation Event. The return set forth in the brackets are for illustration purposes only and may not reflect current trend. The Investor Group may request a higher return than that set forth in this Term Sheet. [↑](#footnote-ref-10)
11. When considered in view of the first sentence of this provision, this permits the holders of the Series B Preferred Stock to receive their desired return on investment and then share *pro rata* with all of the other shareholders (on an as converted basis) with whatever is left over. This can significantly reduce the amount available for the common stockholders. The counter position that the Company can take is to resist providing a significant preference return if the Series B Preferred Stock is to participate in the remaining amount or insist instead that the Series B Preferred Stockholders only receive the preference return (unless they instead convert their Series B Preferred Stock into common stock). [↑](#footnote-ref-11)
12. The definitive agreement likely will include a more detailed definition of what constitutes a Liquidity Event (or a Change of Control). [↑](#footnote-ref-12)
13. The automatic conversion for an IPO may have a variety of metrics to ensure that the offering will be at a price that permits the holders of the Series B Preferred Stock to receive their desired return on investment. In essence, this makes it difficult for the Company to undertake an IPO at a lesser price because the Series B Preferred Stock will potentially remain outstanding. It should be noted that the Series B Preferred Stockholders, either directly or through their representatives on the board of directors, often retain the ability to significantly control this process in any event. [↑](#footnote-ref-13)
14. This is a provision that is subject to significant negotiation and the Company may seek to exclude it altogether from the terms of the Transaction. The Investor Group seeks such a provision to ensure that there is a timely exit strategy for its investment in the Company. However, it also places significant pressures on the Company to grow its available cash flow or to engage in a Liquidity Event or a Qualified IPO within the time frame specified. To the extent that the Investor Group insists on including this provision, the Company must consider the consequences of not having sufficient cash proceeds available for any such redemption and whether there are alternatives to a cash payment or default (which may cause the triggering of a Liquidity Event to the detriment of the non-Series B Preferred Stockholders). [↑](#footnote-ref-14)
15. To the extent that redemption provision is included, consider the feasibility of the timing requirements in light of the proposed redemption payment amount. [↑](#footnote-ref-15)
16. Sometimes the Investor Group will not require any action by the majority of Series B Preferred Stockholders and the right will exist for each holder automatically. [↑](#footnote-ref-16)
17. If the Company is required to redeem the Series B Preferred Stock in the future, it may wish to negotiate for the payment of such amounts in the form of a promissory note in the event that it lacks the cash necessary for a redemption. As indicated above, there are numerous issues to consider under such circumstances. Alternatively (or in addition to the foregoing), the Company might desire to negotiate a delay in the redemption right under certain specified situations. [↑](#footnote-ref-17)
18. If the Company issues Common Stock at a price which is below the then-conversion price of the Series B Preferred Stock (which initially is the Purchase Price), the conversion ratio will adjust to preserve the value of the Common Stock that is issuable upon conversion of the Series B Preferred Stock. The manner of the adjustment, however, can have a significant impact. A full ratchet basis adjustment means that the conversion price falls to the lowest price paid for the Common Stock (other than for certain exclusions discussed below) regardless of the number of shares sold and the impact that it has on the amount of money being raised by the Company in the subsequent dilutive financing. The “weighted average” approach takes into account the number of shares issued at the reduced price when adjusting the conversion price. Further, the weighted average can be determined on: (a) all the Common Stock outstanding (including all Common Stock issuable upon conversion of its preferred stock) as well as the number of shares of Common Stock which could be obtained by converting all other options, rights, and securities (including employee options)(“broad based weighted average”) or (b) only on currently outstanding Common Stock (“narrow based weighted average”). As an alternative, a full ratchet adjustment could be conditioned on certain factors, such as the Investor Group purchasing their *pro rata* shares of the dilutive issuance (“pay to play”) and the failure to do so would cause the anti-dilution provisions to cease for non-participating holders, or which excludes a follow-on offering that raises a specified threshold dollar amount. [↑](#footnote-ref-18)
19. This list should include shares of Common Stock issuable upon conversion of Junior Preferred Stock and any warrants issued to the Investor Group pursuant to the Transaction. [↑](#footnote-ref-19)
20. These types of transactions are handled in the section “Adjustments Upon Recapitalization.” [↑](#footnote-ref-20)
21. In order to protect its investment in the event of a non-dilutive proposed sale of the Company’s equity in the future (e.g., Common Stock), the Investor Group may wish to have the chance to make the first or last offer to purchase such securities, or to exercise pre-emptive rights. In the case of a right of first offer, the Investor Group would have the right to purchase any proposed offering prior to the Company seeking other investors. In the case of a last offer, the Investor Group would instead be given the right to match the terms of any bona fide offer after the Company has identified and negotiated the terms of the offering with other investors. This Term Sheet only includes the pre-emptive rights alternative. [↑](#footnote-ref-21)
22. This provision does not apply to the securities purchased by the Investor Group. The Right of First Offer (below), if agreed to by the parties, is the provision that applies to the securities held by the Investor Group. [↑](#footnote-ref-22)
23. Companies may seek to require that the drag along right only applies if the sales price exceeds a stated threshold dollar amount, subject to adjustment. [↑](#footnote-ref-23)
24. The Series B Preferred Stock and the shares of Common Stock in to which the Series B Preferred Stock may be converted will be offered and sold to the Investor Group in this offering pursuant to an exemption from registration under the Securities Act of 1933 (“Securities Act”). The Securities Act, in general, provides that securities may not be offered or sold except pursuant to a registration statement declared effective under the Securities Act (which will require registration with the Securities and Exchange Commission (“SEC”) under the Securities Act) or pursuant to an exemption from registration thereunder. It is common for the Investor Group to require the Company to agree to register under the Securities Act in the future the Common Stock into which the Series B Preferred Stock may be converted so that the Investors will be able to publicly re-sell such securities. Registration rights generally consists of demand registration rights and “piggyback registration rights.” Demand registration rights provide investors with the ability to require the Company to file a registration statement to register their securities. Piggyback registration rights, in contrast, permit investors to include their securities in certain other registration of securities being undertaken by the Company. Generally an Investor Group will require that it be furnished both of these registration rights and such rights are typically set forth in a separate Registration Rights Agreement. If the Investor Group only receives piggyback registration rights, the Investor Group will be unable to initiate the registration process and its liquidity options will be limited. The negotiation of registration rights include matters such as the number of times certain registration rights may be requested, how long will such rights be available, the notice requirements and procedures to be followed, the fight of the company to delay such offerings, and the restraints that may be imposed by underwriters (with respect to piggyback registration rights). Such registration rights provided to the Investor Group often are reflected in a separate Registration Rights Agreement. [↑](#footnote-ref-24)
25. This rights set forth in this paragraph relate to demand registration rights provided to the Investor Group. [↑](#footnote-ref-25)
26. The preparation, planning and filing of a long form registration statement with the SEC is an expensive and time-consuming exercise and most companies wish to retain control over a determination of whether or when it should conduct an initial public offering and thereby become subject to the periodic public reporting obligations of a publicly traded company. As a result, demand registration rights typically will not be available until the Company has conducted an initial public offering and the right to demand a long form registration will be limited in number. [↑](#footnote-ref-26)
27. The Company should consider limiting its obligation hereunder only to the registration of Common Stock. The requirement that the registration statement cover the “Registrable Securities,” as defined, would include any request to register the Series B Preferred Stock. [↑](#footnote-ref-27)
28. The agreement to file a long form registration statement has all of the cost associated with a public offering and, as a result, there should be a minimum offering raise in order to make it worthwhile for the Company to incur such costs and time commitments. Further, the Company should be permitted to include its own shares in the registration statement so that the Company also can raise capital from the sale of its shares. [↑](#footnote-ref-28)
29. Although this provision affords the Investor Group with an unlimited right to participate in such offerings, the Company should negotiate a time limitations or other limitations to this right. [↑](#footnote-ref-29)
30. A Form S-3 is a short form registration statement (as opposed to the long form registration statement referenced in the preceding footnotes relating to demand registration rights) where the Company can incorporate by reference prior filings made with the Securities and Exchange Commission (meaning the Company is already a public reporting company). Among other things, a Form S-3 can be used under certain circumstances to register shares held by selling shareholders. Typically Investor Groups will seek unlimited rights to demand registration on Form S-3. Although the preparation of a Form S-3 Registration Statement is less expensive than a long form registration statement, consideration still should be given to requiring a minimum offering raise as a condition to demanding registration on Form S-3 in order to make it worthwhile for the Company to incur the costs and time commitments. It is worth noting, however, that the SEC has recently revised its rules to permit certain companies that have been public for over one year and that satisfy certain other conditions to incorporate prior filings by reference into the long form registration statement. Demand registration rights provisions may be revised in the future to take advantage of this new development. [↑](#footnote-ref-30)
31. This applies to proposed sales of the securities by the Investor and provides the Company with an opportunity to purchase the shares before the Investor sells such shares to a third party. It is not a provision that is included in all offerings of this type and, to the extent that the Company does not have the cash available to purchase such shares, it may not be a particularly useful right for the Company. Sometimes the securities held by the Investor Group may instead be subject to certain limited rights of first refusal, but such restrictions are typically resisted by investors at this stage of capital raising activities. This should not be confused with a potential right of fisrt or last offer made to an Investor as referenced in footnote 21 above with respect to new issuances of securities by the Company. [↑](#footnote-ref-31)
32. These are provisions designed to protect the rights of the holders of the Preferred Stock and their investment in the Company. Certain of the proposed restrictions are heavily negotiated. These provisions may be contained in different documents (i.e., the Articles of Incorporation or Certificate of Incorporation (more precisely, the Articles of Amendment or the Certificate of Designations, as the case may be, establishing the Preferred Stock) with respect to basic rights of the Preferred Stockholders and the Shareholders Agreement. [↑](#footnote-ref-32)
33. The Investor Group likely will require representation on the Board of Directors and will limit the size of the Board to ensure that their representation will not be diluted by the election or appointment of additional directors. An issue may arise if holders of any Junior Preferred Stock also have rights to Board representation and/or the Founder requires representation on the Board. This provision also may include a requirement for an independent director and a director from the management ranks. The nomination and election of the Series B Preferred Directors designated by the Investor Group will be affirmatively agreed to by the Company, the shareholders, and the Investor Group in a Shareholders Agreement (or similar agreement). Often, the Investor Group also will require representation by the Series B Preferred Directors on various committees of the Company (i.e., audit, compensation, corporate governance, etc.) and may require certain approval rights as members of these committees. This right should be conditioned upon the Investor Group maintaining a minimum threshold of ownership in the Company and should terminate following an initial public offering (even if it does not constitute a Qualified Public Offering). [↑](#footnote-ref-33)
34. This allows the Company to take actions at the Board level without seeking the approval of the holders of the Series B Preferred Stock (and some of the items referenced in the Protective Provisions are sometimes moved to this provision during negotiations). These restrictions typically relate more to the general operations of the business, as opposed to structural changes to the corporation that may adversely affect the substantive provisions of the Series B Preferred Stock itself. If the Series B Preferred Directors do not control the Board, the Investor Group may require that, in addition to approval of the majority of the Board, that such actions be approved by a majority of the Series B Preferred Directors. [↑](#footnote-ref-34)
35. Investor groups typically require that there be a higher dividend rate payable on the Preferred Stock if there is an Event of Non-Compliance to compensate them for the additional risk (to the extent they do not require immediate redemption), and that they have control of the Board during any such period. If the Event of Non-Compliance is later satisfied, the original dividend rate would again apply thereafter and the Board would return to its original configuration. [↑](#footnote-ref-35)
36. An Investor Group may not wish to receive such information after the Company becomes a public company (regardless of whether the offering was a Qualified Public Offering) because it may restrict their ability to sell such shares into the public markets due to the prohibition on trading shares while in the possession of material nonpublic information. [↑](#footnote-ref-36)
37. Often, the Term Sheet will require key employees and executive officers to enter into an employment or other agreement which will contain such provisions, as well as provisions relating to the ownership of and assignment to the Company of all intellectual property authored or invented by the employees, as well as the confidentiality obligations. [↑](#footnote-ref-37)
38. As a condition to the investment, the Investor Group may require the Company to obtain Directors’ and Officers’ Liability Insurance coverage, amend the corporate governance documents to provide directors with the maximum indemnification permitted under law (including the advance of expenses), and key man insurance if the Company is heavily dependent on one or more officers. [↑](#footnote-ref-38)
39. Typically the law of the state of incorporation of the Company will govern. [↑](#footnote-ref-39)