General Considerations

1. Contract terms embody allocations of cash flow streams in both amount and timing, allocation of risk and allocation of value.

2. Law is a source of bargaining leverage, but is rarely a “show-stopper”. The background law, with its default rules, creates a cost advantage to the party who benefits from those rules.

3. Deals over time are different from one-shot deals. Uncertainty increases and relationships matter. Balance the carrot and the stick, e.g., milestone financing.

4. Contract law is an enforcement mechanism. It exists to enforce privately negotiated bargains, not to dictate the terms.

5. Corporate law – the law of the structure of the prevailing type of business organization – incorporates a well-understood off-the-rack system of rights and obligations, If you don’t understand these basic structures, you will not know what you are giving away. e.g., quorum and voting mechanisms: failure to deal with quorum can undercut voting rights.
The ABC Corporation term sheet:

What sort of investment is this: seed financing, startup financing, first-stage financing or second stage financing?

Who is doing this financing and what does that tell you?

What protections do the investors have?

1. Economic:
   a. Dividends (p.1)
   b. Liquidation preference (p.2)
   c. Antidilution (p.2)
   d. forced redemption (p.3)
   e. rights of first refusal (p.4)

2. Governance:
   a. Voting rights (p.3)
   b. Board representation (p.6)
   c. Class voting / “Protective Provisions” (p.3)
   d. Supermajority voting at Board level (p.3)
   e. Information Rights (p.4)

3. Contract
   a. Confidentiality / inventions agreements (p.6)
   b. Stock purchase agreement (p.5)

What are the exit provisions and timing for each?

1. Redemption and liquidation provisions
2. Registration rights
3. Co-sale/ First refusal
Selected Terms to compare to ABC Term Sheet Terms (2002):

Liquidation Preference

In the event of liquidation, dissolution or winding up of the Company, each holder of the Preferred will be entitled to receive in preference to the holders of common stock an amount equal to the greater of (1) three times their respective original purchase price plus any accrued but unpaid dividends or (2) the amount they would have received had they converted the Preferred to Common immediately prior to such liquidation or winding up. A consolidation or merger of the Company or sale of all or substantially all of its assets will be deemed to be a liquidation or winding up for the purposes of the liquidation preference.

Antidilution Adjustments

Subject to certain exceptions (including, without limitation, transactions approved by the Board of Directors that involve the issuance of the Company’s securities to an entity primarily for purposes other than raising capital and as an integral component of a larger business relationship subject to a maximum per transactions or series of related transactions of 3% of the Company’s outstanding capital stock), the conversion price of the Preferred will be adjusted on a full-ratchet basis (i.e. the conversion price of the Preferred will be adjusted to equal the per share price of the shares issued in the dilutive issuance) for subsequent issuance of the common stock (or options or convertibles) below the applicable conversion price then in effect, or in the event the Company subdivides (by any stock split, stock dividend, recapitalization or otherwise) or combines (by reverse stock split or otherwise) its outstanding shares of common stock into a great or smaller number of shares, or in the event of any capital reorganization, reclassification, consolidation, merger, lease or sale of all or substantially all of the Company’s assets in such a way that holders of common stock are entitled to receive stock, securities or assets with respect to or in exchange for shares of common stock.
Voting Rights

.... The affirmative vote of the holders of not less than a majority of the Preferred will be necessary to authorize the following actions by the Company:
- a sale of all or substantially all of the assets of property of the Company,
- an amendment or repeat of the Company’s Certificate of Incorporation
- a consolidation or merger of the Company
- a dissolution, liquidation or winding up of the Company
- an amendment or repeat of any provision of the Company’s bylaws that would adversely affect the economics or rights of the holders of the Preferred, including, without limitation, those provisions concerning the size, composition or election of the board of directors and those provisions governing the vote required to amend the bylaws
- the authorization of issuance of any additional shares of capital stock of the Company that are pari passu or senior to the Preferred
- incurring or agreeing to incur more than [$1,000,000] of debt financing
- payment of dividends on, or redemption of, any capital stock of the Company (except in connection with the redemption provisions provided for herein and in connection with certain specified repurchases of shares held by employees of the Company)
- a change in the nature of the Company’s business, or entering into new businesses, and
- the acquisition of an interest in another business entity whose business is not similar to or supportive of the business of the Company as currently conducted.