

# **A Guide To Venture Capital Term Sheets**



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# I Introduction

Although venture capital is a well-established source of funds for early stage companies in overseas jurisdictions and the process of venture capital investment is well understood, the availability of venture capital has been limited in New Zealand until recently and the process is not so well understood here. However, recent fund raising activity (spurred by initiatives like the government funded New Zealand Venture Investment Fund) has raised awareness and availability of this form of funding in New Zealand.

There are significant differences in the nature of venture capital investment depending on the stage of investment and a privately funded company might have a number of funding rounds. The first round is often to raise a small amount of money (*seed capital*), typically from friends or family or high net worth individuals (often referred to as *angels*). Occasionally a specialist early stage venture capital investor might invest at this stage. For rounds without a venture capital investor there may or may not be formal investment documents.

Venture capital is typically the most active form of investment. This fact and the high risk nature of venture capital distinguish it from other types of finance and investment and largely explain why typical venture capital terms are quite different in many respects to terms which typically apply to other types of investment. The most striking difference is the preferential rights usually required by a venture capital investor. Accordingly, it is important for a company seeking venture capital to try and match the venture capitalist's skills with the requirements of its business to ensure it gets value for the preferential equity terms.

There are two main sources of institutional venture capital funding: venture capital funds (usually the most active type of the investors) and strategic corporate investors.

The first round of investment from venture capitalists is usually called a *Series A* round, with subsequent rounds progressing through the alphabet. This Guide reviews those terms that may be included in a Term Sheet for a Series A or for subsequent investment rounds, although not every term discussed will be necessarily appropriate for every investment. Sometimes investments are made by way of debt (usually convertible to equity), but the majority of investments are made by way of a purchase of shares. This Guide deals only with the latter.

The aim of this Guide is to provide those who are not familiar with the venture capital investment process with an outline of how investments can be structured, the terms and terminology typically used in a Term Sheet and the broader investment process. It is hoped that this familiarity will assist those who are trying to raise venture capital by helping them to understand the commercial implications of the terms being offered. This in turn will hopefully expedite the negotiation of Term Sheets and completion of the investment process.

After the section outlining the purpose of a Term Sheet, there is a section describing the investment process with some worked examples of how the share structure alters in certain circumstances. There is also a glossary of terms used in venture capital transactions. Where each term is used for the first time in this Guide it is in italics. The terms addressed in this Guide will not be appropriate for every venture capital investment, but should cover most of the terms typically used in New Zealand.

It should be noted that *private equity* is the generally accepted term used to describe the industry as a whole, encompassing both management buy-out and buy-in activity, while *venture capital* describes the subject of private equity ranging from seed through to expansion stages of investment. This Guide is relevant primarily to the venture capital stages of investment and so this will be the term used.

This guide is based on a similar guide produced by the British Venture Capital Association. The New Zealand Venture Capital Association ("NZVCA") is grateful to the British Venture Capital Association for its permission to use its guide, to Simpson Grierson for adapting the guide for New Zealand practice and conditions and to the New Zealand Venture Investment Fund for its role in promoting and supporting the preparation of this guide for the benefit of the New Zealand industry.

If you have any queries concerning this guide which you would like to discuss, feel free to contact Simpson Grierson partner (and venture capital specialist) Andrew Lewis <mailto:andrew.lewis@simpsongrierson.com> who was responsible for adapting the guide to New Zealand conditions.

## II What is a Term Sheet?

A Term Sheet is a document which outlines the key financial and other terms of a proposed investment. Investors use a Term Sheet to achieve preliminary and conditional agreement to those key terms and form the basis for drafting the investment documents. With the exception of certain clauses (commonly those dealing with confidentiality, exclusivity and sometimes costs and break fees) provisions of a Term Sheet are not usually intended to be legally binding. As well as being subject to negotiation of the final legal documentation, a Term Sheet will usually contain certain conditions which need to be met before the investment is completed and these are known as *conditions precedent* (see section 26, Part IV).

The principal documents which will usually govern venture capital needed for an investment round in New Zealand are a *Subscription Agreement* and a *Shareholders' Agreement* (although frequently these are combined into a single Subscription and Shareholders' Agreement or *Investment Agreement*). A customised *Constitution* is also usually prepared. The provisions of the Term Sheet will be included in greater detail in these documents.

The Subscription Agreement will usually contain details of the investment round, including the number and class of shares subscribed for, payment terms and *representations and warranties* about the condition of the company and its key assets (see section 13, Part IV). These representations and warranties will usually be qualified by a *disclosure letter* and supporting documents that specifically set out any issues that the founders believe the investors should know prior to the *completion* of the investment.

The Shareholders' Agreement will usually contain investor protections, including *consent rights* (see section 15, Part IV), rights to board representation and *non-compete* restrictions. The Constitution will include the rights attaching to the various share classes, the procedures for the issue and transfer of shares and the holding of shareholder and board meetings.

Some of the protective and other provisions in the Shareholders' Agreement may be contained or repeated in the Constitution. The decision to include terms in one or both of these documents may be influenced by company law restrictions and confidentiality concerns (constitutions must be filed as a public document at the Companies Office, while the other investment documents can often be kept confidential).

A venture capital investment round is usually made, or if syndicated led, by one venture capital firm. If syndicated, the *lead investor* will put together a syndicate either before or after the Term Sheet is agreed and then co-ordinate the syndicate until the round is completed.

Once agreed by all parties, lawyers use the Term Sheet as a basis for drafting the investment documents. The more detailed the Term Sheet, the fewer the commercial issues which will still need to be agreed during the drafting process. The process can be complex and working with lawyers who are familiar with venture capital transactions is recommended in order to minimise both timeframe and costs.

### III The Investment Process

In order to help explain some of the concepts that will be contained in this Guide it is useful to follow the practical example in this Part which follows a company from establishment to its Series A funding round. **This example should not be taken as representing a standard process or representing typical valuations or percentage ownerships. At each stage each case will be different and will need to be handled on an individual basis.**

'NewCo' is a company spun out from an academic institution to exploit *intellectual property* developed by the scientist (the founder) whilst working as an employee of that institution. The academic institution has agreed to transfer (assign) its ownership rights in the intellectual property rights (IPR) to NewCo in return for a 50% shareholding in the business. It has also agreed that the founder who has carried out the research that led to the creation of the IPR should own the other 50% through a holding of *founder shares* (see section 9, Part IV). The capital structure of NewCo is as set out in Box 1.

#### Box 1. Capital structure for NewCo following establishment of the company and assignment of intellectual property

Start-up		
	Number of ordinary shares	Cash or cash equivalent invested at \$1 per share
Founder	50	\$50
Institution	50	\$50
<b>Undiluted share capital</b>	<b>100</b>	<b>\$100</b>

The investment by the founder is satisfied by a cash payment and the investment by the academic institution is satisfied by the transfer of IPR to NewCo. With the help of the academic institution and the founder's network of contacts, NewCo then successfully attracts the investment of a venture capitalist (seed investor) that specialises in investing in very early stage companies.

On the basis of the reputation of the scientist, the strength of the IPR and the potential market for the products arising from the technology, the seed investor and NewCo agree that the *pre-money valuation* (see section 2, Part IV) for NewCo is \$200,000. From discussions between the seed investor and NewCo it is also agreed that the company needs to raise \$200,000 to enable it to carry out some key experiments to establish the proof of principle for the technology and therefore enable it to raise its next funding round. The seed investor also requires that an *option pool* (see section 21, Part IV) be established to help attract new staff to join NewCo.

With these parameters agreed the capital structure of NewCo following the investment by the seed investor is as set out in Box 2.

**Box 2. Capital structure following seed round**

Seed round	Cash or cash equivalent invested	Number of 'A' shares issued at this round	Undiluted total ordinary shares and 'A' shares	Options	Fully diluted equity	Value of shares
Founder(s)	\$50	0	50	0	50	\$100,000
Institution	\$50	0	50	0	50	\$100,000
Seed investment	\$200,000	100	100	0	100	\$200,000
Option pool				20	20	
Total	\$200,000	100	200	20	220	\$400,000

## IV What terms are typically included in a Term Sheet?

### 1. Type of share

A venture capital investor will normally only subscribe for a preferred class of shares. These are shares which enjoy rights that are not shared by ordinary shares held by the founders and others. There are a number of reasons why venture capital investors require these additional rights. They include:

- in most cases the venture capitalist is investing much larger sums than the founders (whose investment usually takes the form of good ideas, time and a small amount of seed money) and at a higher valuation;
- the venture capitalist will often provide the strategic direction, structure, contacts and guidance which is critical to the company's success and growth. A preferred and possibly additional return may be required to recognise that contribution;
- the founder(s) will often draw a salary for their contribution and input and participate in an *employee share option scheme (ESOP)* (which dilutes the venture capitalist's shareholding);

- typically the earlier the investment stage, the higher the investment risk, the more scarce the available capital and the greater the compensatory preference sought by the venture capitalist.

If a preferred share class already exists at the time of an investment round, the new round of investors will typically create a new series of preferred shares to distinguish the rights (voting, financial, etc.) that attach to their preferred series from those that attach to all prior series of shares. Distinguishing the rights enjoyed by different series is common practice because the investments made at the time of the creation of each series are usually based on different company valuations and circumstances and, consequently, have different risk profiles.

## 2. Valuation and milestones

The venture capital investors will agree with the company on a valuation for the company prior to the new investment round (the pre-money valuation). The pre-money valuation is used to determine the price per share to be paid by investors on the completion of the new investment round (the subscription price). The subscription price is calculated by dividing the pre-money valuation by the fully diluted number of shares of the company immediately prior to the time of completion. In the example in Part III the pre-money valuation agreed is \$200,000 and immediately prior to completion there are 100 ordinary shares. The value of those shares and therefore the subscription price for the incoming investor is  $\$200,000/100$  which equals \$2,000 per share.

The term 'fully diluted' usually takes account of shares that have been issued by the company, shares allocated to the employee option pool (see section 21 below) and any other shares which the company could be required to issue through *options*, *warrants*, *convertible debt* or other commitments. The pre-money valuation should be distinguished from the *post-money valuation*, which refers to the valuation of the company immediately following (and which includes the investment proceeds from) the new round. Therefore, following completion of a venture capital seed round in the example in Part III, NewCo has an undiluted post-money valuation of \$400,000 represented by a \$200,000 pre-money valuation and \$200,000 of investment. If the option pool is included in the calculation, the fully diluted post-money valuation is \$440,000 i.e.  $\$2,000 \times (200 \text{ shares} + 20 \text{ options})$ .

Quite often, venture capital investors will not wish to make all of their investment on completion. Instead they will invest in *tranches*, subject to various technical and/or commercial targets (*milestones*) being met. These milestones will be set out in the Subscription Agreement. Failure to meet a milestone does not automatically mean that the investors will not provide the money contingent on that milestone. In that circumstance, the provision of the relevant portion of the investment will be at the venture capitalist's option and this may mean that they will seek to negotiate different terms for these amounts.

Sometimes a mechanism, a *ratchet* is used to require an adjustment to the respective shareholdings of the investors and the founders depending on either the company's performance or the level of returns on an exit (exit ratchet). This technique is principally used to find a bridge between widely differing views of a company's value, or to provide additional incentives/rewards to the founders for delivering excellent returns to the investors. Ratchets can be complicated in operation and need to be



very carefully thought through to address tax issues and in order to avoid future conflicts of interest between the venture capital investor, the founders, the company and potential future shareholders at a later date.

### 3. Dividend rights

Venture capital investors often invest in early stage companies that are in an intense growth phase. The objective is to grow the business and its value and to realise a *return on investment (ROI)*, (typically targeting a multiple of the amounts invested) on exit. In most cases the investee company should be reinvesting all profits to continue growing the company, rather than paying *dividends* to shareholders. Sometimes there is a prohibition on the payment of any dividend, which may last for a limited period of time.

Even if the payment of dividends is permitted, one way the company is restricted from paying dividends while it is growing is to provide the venture capital investors with a share class that has a preferential, *cumulative dividend*, usually fixed at a percentage of the subscription price paid for each preferred share. The company will also be prevented from paying any dividend to other shareholders until the dividend is paid to the holders of the preferred shares. Since that dividend accumulates, usually until an exit (see section 18 below), it effectively prevents any other dividend being paid until then. In addition, investors will often have an overriding right to veto the payment of any dividend.

If a dividend is cumulative, it means that for each period that the dividend accrues (e.g. quarterly or annually) any amounts not paid are accumulated until the company has the necessary cash. At that time the accrued amounts must be paid to the investors' share class in their entirety, before any dividends can be paid to other share classes. If the preferred shares are converted into ordinary shares, the investors will usually expect all accumulated dividends to be paid or *capitalised* into ordinary shares on such *conversion*.

In addition to a dividend preference, venture capital investors typically require that the preferred shares be entitled to participate in any distributions on the ordinary shares, or in other words, to enjoy a pro rata share of any dividends paid to the ordinary shares on top of any dividend preference paid only to the preferred shares.

### 4. Liquidation preference and deemed liquidation

The *liquidation preference* is a right which can be required by venture capital investors in recognition of a range of factors which include those described in section 1 of this Part (see page 6 [but there are no page numbers?]).

While there are many variations, the liquidation preference typically provides that, in the event the company is liquidated or subject to a *deemed liquidation* (see below), the preferred shareholders will receive a certain amount of the proceeds before any other shareholders. This preference amount may be equal to the amount of the preferred shareholders' investment, or a multiple of it (three times is not uncommon).

The remaining proceeds are often then shared amongst the preferred and ordinary shareholders. There are numerous ways in which this may be effected, but the most common are:



- Pro-rata: the remaining proceeds are shared pro rata, according to their percentage shareholding, among the preferred and ordinary shareholders (in which case the preferred shares are considered *fully participating*, i.e. after receiving the preference amount, the preferred shareholders participate fully with the ordinary shareholders in sharing the remaining proceeds); or
- Catch-up, then Pro-rata: after payment of the liquidation preference amount, the ordinary shareholders may "catch up" by receiving an amount equal to the amount paid by them or credited as paid by them for their shares and thereafter the remaining proceeds are shared on a pro rata basis between all shareholders as above.

The size and structure of the liquidation preference will be negotiated to reflect the risk inherent in each investment round. The higher the risk, the higher the required return. Many factors (including the valuation of the company) will be considered in this calculation.

Venture capital investors usually require that the liquidation preference applies not only in connection with a *liquidation or winding up* of the company, but also in the case of a "deemed liquidation", a term usually defined to include an amalgamation, acquisition, change of control or consolidation of the company, or a sale of all or most of its assets. Sometimes the term also includes an *initial public offering (IPO)* or a qualified exit (see section 18 below).

The example below shows respective returns which will be achieved by each investor if there were *liquidity events* at the value of \$200,000 or \$1,000,000 in each of the following scenarios (all of which assume a fully participating liquidation preference based upon the issued share capital following the seed round described in Box 2 of Part III):

Where there is no liquidation preference attached to the 'A' shares

1 x liquidation preference then pro rata (no catch up)

2 x liquidation preference then pro rata (no catch up)

2 x liquidation preference, catch up and then pro rata

Liquidated Preference	Percentage Shareholding	\$200,000 liquidity event cash return	\$1,000,000 liquidity event cash return
<b>Investor</b>	50%		
None		\$100,000	\$500,000
1x		\$200,000	\$600,000 (\$200,000 preference plus 50% share in \$800,000 balance)
2x		\$200,000	\$700,000 (\$400,000 preference plus 50% share in \$600,000 balance)
2x, catch-up		\$200,000	\$650,000 (\$400,000 preference plus 50% of \$500,000)
<b>University</b>	25%		
None		\$50,000	\$250,000
1x		0	\$200,000 (25% of \$800,000)
2x		0	\$150,000 (25% of \$600,000)
2x catch-up		0	\$175,000 (\$50,000 catch-up and 25% of \$500,000)
<b>Founder</b>	25%		
None		\$50,000	\$250,000 (As for University)
1x		0	\$200,000
2x		0	\$150,000

2x catch-up		0	\$175,000
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In this example, in the event the company is only sold for \$200,000 the investor will only get his money back if he has negotiated a liquidation preference so that the first \$200,000 from such an event goes to the investor. In the event of a sale at \$1,000,000 the calculation works so that in the event of 1x preference the first \$200,000 goes to the investor and then the remaining \$800,000 is shared pro rata in accordance with the shareholding, in this case 50:25:25.

## 5. Redemption

The right of redemption is the right to demand under certain conditions that the company buys back its own shares from its investors at a fixed price. This right may be included to require a company to buy back its shares if there has not been an exit within a pre-determined period. Failure to redeem shares when requested might result in the investors gaining improved rights, such as enhanced voting rights. A right of redemption is not appropriate for every investment and in New Zealand and certain other jurisdictions, there are legal requirements that must be satisfied before a company can redeem any of its shares (not least, the company must satisfy both the balance sheet and cashflow limbs of the solvency test contained in the New Zealand Companies Act after redemption). A right of redemption can also be used by an investor where it needs to strongly discourage a company from breaching certain obligations.

## 6. Conversion rights

Where venture capital investors hold a preferred class of shares they generally require the right to convert them at any time to ordinary shares, at an initial *conversion ratio* of 1:1. *Conversion* is normally delayed until exit so that investors are able to avoid losing the rights attached to the preferred class of shares. The conversion ratio will be adjusted to take account of any reorganisation of a company's capital structure. The conversion ratio can also be adjusted to provide anti-dilution protection (see section 8 below).

## 7. Automatic conversion of share class/series

Investors will often be required to convert all of their shares into ordinary shares prior to a company *listing* its shares on a publicly traded exchange. Similarly, venture capital investors often require an automatic conversion mechanism for all share classes, effective immediately prior to an IPO. Investors will only want this conversion mechanism to work where an IPO is likely to provide a sufficient opportunity for them to dispose of their shares (*liquidity*) after the expiry of any *lock up* periods at a price which provides an acceptable return. Accordingly the investors often define certain criteria in advance that must be met for an IPO to trigger automatic conversion (usually referred to as a *Qualified IPO*), e.g. only offerings on certain exchanges, supported by recognised underwriters, at a valuation exceeding a certain threshold and raising at least a minimum amount of gross proceeds. Otherwise, preferred shareholders could risk having their shares converted and losing all of their preferential rights even if the company lists its shares at a low value and/or on a minor exchange.

## 8. Anti-dilution (or price protection)

Venture capital investors often require anti-dilution protection rights to protect the value of their stake in the company, if new shares are issued at a valuation which is lower than that at which they originally invested (a *down round*). This protection usually functions by applying a mathematical formula to calculate a number of new shares which the investors will receive, for no or minimal cost, to offset the dilutive effect of the issue of cheaper shares.

There are several variations of the formula, each providing different degrees of protection. These include *full ratchet* protection, which will result in additional shares being issued to the investor to either maintain its percentage ownership at the same level or so that its effective price per share is the same as the share price for the down round. Other versions of the formula provide some compensation for the *dilution*, but allow the ownership percentage to fall, most commonly by a *weighted average* formula. The level of protection required by an investor depends on several factors, including the valuation of the company at the time of the investment and the perceived exposure to further financing requirements.

While the basic concept remains the same, there are several different mechanisms used to create this protection. One mechanism is adjusting the conversion ratio of preferred shares to ordinary shares to adjust for dilution. Other methods include the issue of shares for a nominal sum or by way of bonus issue. Another method would involve the granting of options (or warrants as they are sometimes referred to), which are only exercisable if the *anti-dilution provision* is triggered.

In the example set out in Box 2 of Part III, if the project did not proceed as well as expected and, when the time came to raise another round from new investors, it emerged that these potential new investors were only prepared to invest at a pre-money valuation (for them) of \$200,000, this would imply that they would only pay \$1,000 per share (\$200,000/200). However the existing investors paid \$2,000 per share and therefore, under full anti-dilution provisions, their shareholding would be adjusted in order to issue them with new shares, the effect of which would be to reduce the price they paid for the 'A' shares to \$1,000 per share.

The result of the full anti-dilution provisions is that the existing investors would have to be issued with a further 100 shares to bring their shareholding to 200 for which they paid a total of \$200,000 which equals \$1,000 per share. In terms of the overall shareholding, this would alter the ownership of the business between the founders, academic institution and investors to 50 shares: 50 shares: 200 shares or 16.6%:16.6%:66.6% (a change from 50 shares: 50 shares: 100 shares or 25%:25%:50%).

## 9. Founder shares

Founders and senior management are usually central to the decision of venture capital investors to put money into a company. Having decided to put money behind a management team they have confidence in, investors are usually keen to ensure that the founders remain to deliver their business plan. Therefore, it is often the case that founders and key managers (and sometimes all shareholders/employees who leave the company within a certain period of time) are required to offer to sell their shares back to the company or to other shareholders. The price paid for the shares may depend upon circumstances of departure. It may be at market value if the founder/manager is deemed to be a *good leaver*, or it might be considerably less in the case of a *bad leaver*. Someone who has breached his contract of employment

will invariably be a bad leaver but the term may also be extended to someone who resigns from the company within a particular period. The Board often retains the right to determine whether to implement the bad leaver provisions.

In addition, or as an alternative to, good leaver/bad leaver provisions, investors may require that shares held by founders who are employees or consultants be subject to a *vesting* schedule in order to encourage the founders not to leave employment with the company in the short term. The effect of this is that anyone holding such shares must be employed or engaged as a consultant by the company for a certain period of time if that person is to obtain unrestricted ownership of all of their shares. Within that period shares may vest on a straight-line basis or on whatever basis is negotiated. Sometimes founders have different vesting schedules in recognition of their different levels of contribution to the company. Taxation advice is recommended when structuring any vesting arrangement, to minimise any adverse tax implications for the founders in particular.

In NewCo it was decided that the founder's 50 shares would vest on a straight-line basis over 4 years, with the first year's allocation vesting on the completion of the venture capital investment.

Number of Shares	0 months – 12 months	12 months – 24 months	24 months – 36 months	36 months – 48 months
Annual vesting %	12.5	12.5	12.5	12.5
Cumulative vesting %	12.5	25	37.5	50

If a founder leaves within the relevant period, he will keep only that proportion of his shares that are deemed to be vested. In this example, if the founder left between 12-24 months, 25 shares or 50% of the shareholding would have vested. The remaining shares that are unvested would be typically be bought back by the company for a nominal amount. It may be decided that on certain events such as death or incapacity or where a founder's employment may terminate through no fault of their own, the vesting schedule is accelerated either partially or fully. The Board may retain the right to determine such issues at the time, in the light of circumstances.

## 10. Pre-emption rights on new share issues

If the company makes any future share offering, a venture capital investor will require the right to maintain at least its percentage stake in the company by participating in the new offering up to the amount of its pro rata holding, under the same terms and conditions as other participating investors. This *pre-emption right* will apply by default in New Zealand (and most common law jurisdictions) unless excluded by the company's constitution or waived (in the Investment Agreement or otherwise).

If the new offering is based on a company valuation lower than that used for an investor's prior investment, that investor may also receive shares under its anti-dilution rights (see section 8 above). Certain issues will usually be exempted from the pre-emption rights, including the issue of anti-dilution shares and the issue of shares on the exercise of *share options*.

## 11. Pre-emptive rights on transfer and tag along rights

These are contractual terms between shareholders which are usually included in the constitution. If one shareholder wishes to dispose of shares that are subject to a pre-emptive right, it must first offer them to those other shareholders who have the benefit of the pre-emptive right. There are usually certain exceptions to the pre-emptive right, such as the right of individuals to transfer shares to close relatives and trusts and investors to transfer shares freely to each other or within an investor's group. The requirement to go through a pre-emptive right process may add several weeks to the timescale for selling shares.

If a shareholder wishes to dispose of shares that are the subject of a *tag along right*, the other shareholders who benefit from the right can insist that the potential purchaser agrees to purchase an equivalent percentage of their shares, at the same price and under the same terms and conditions. This may have the effect of making the shares more difficult to sell.

A venture capital investor's decision to invest in a company may be based largely on the strength of the technical and management experience of the founders and management. It does not want these individuals to dispose of their shares in the company while it remains an investor. Consequently, investors usually require pre-emptive rights (which are usually enjoyed by all shareholders) as well as tag along rights on any sale of shares by a founder or key managers. Indeed they may sometimes require a prohibition on founders and key managers selling shares for a stated period. Some investors oppose pre-emptives because it can make their shares more difficult to sell (less liquid) and potentially less valuable since a prospective buyer will often be reluctant to make an offer for shares that can be pre-empted by someone else.

## 12. Drag along or bring along

A *drag along* provision (sometimes called *bring along or follow me*) might create an obligation on all shareholders of the company to sell their shares to a potential purchaser if a certain percentage of the shareholders (or of a specific class of shareholders) vote to sell to that purchaser. Often in early rounds drag along rights can only be enforced with the consent of those holding at least a majority of the shares held by investors. These rights can be useful in the context of a sale where potential purchasers will want to acquire 100% of the shares of the company in order to avoid having responsibilities to minority shareholders after the acquisition. Many jurisdictions provide for such a process, usually when a third party has acquired at least 90% of the shares. In New Zealand there is no compulsory acquisition right for minorities in closely held private companies to require their shares to be purchased, but the Takeovers Code does provide for such acquisition rights for "Code" companies (which include companies listed on a stock exchange or which have more than 50 shareholders or greater than \$20 million assets).

Venture capital investors may require that certain exceptions are included in drag along provisions for situations when they cannot be obligated to sell their shares. Among these are drag along sales where the investors will not receive a specified price in cash or marketable securities in return for their shares (such as would provide the investor with an unacceptable return) or will be required to provide to the purchaser representations and warranties concerning the company (or guarantee those given by the company or the founders) or *covenants* (such as non-compete and non-solicitation of employees).

### 13. Representations and warranties

Venture capital investors expect appropriate representations and warranties to be provided by key founders, management and the company. The primary purpose of the representations and warranties is to provide the investors with a complete and accurate understanding of the current condition of the company and its past history so that the investors can evaluate the risks of investing in the company prior to subscribing for their shares. The representations and warranties will typically cover areas such as the legal existence of the company (including all share capital details), the company's financial statements, the business plan, asset ownership (in particular intellectual property rights), liabilities (contingent or otherwise), material contracts, employees and litigation.

It is very rare that a company is in a perfect state. The warrantors have the opportunity to set out issues which ought to be brought to the attention of the new investors through a *disclosure letter* or schedule of exceptions. This is usually provided by the warrantors and discloses detailed information concerning any exceptions to or carve-outs from the representations and warranties. If a matter is referred to in the disclosure letter the investors are deemed to have notice of it and will not be able to claim for breach of warranty in respect of that matter.

Investors expect those providing representations and warranties about the company to reimburse the investors for the diminution in share value attributable to the representations and warranties being inaccurate or if there are exceptions to them that have not been fully disclosed. There are usually limits to the exposure of the warrantors (ie a dollar cap on the amount that can be recovered from individual warrantors). These are matters for negotiation when documentation is being finalised. The limits may vary according to the severity of the breach, the size of the investment and the financial resources of the warrantors. The limits which typically apply to founders are lower than for the company itself (where the company limit will typically be the sum invested or that sum plus a minimum return).

### 14. Voting rights

Venture capital investors will have voting rights that attach to their class of shares (see section 15 below). Preferred shares may have equivalent voting rights to ordinary shares in a general meeting, although it is also possible that they may carry more than one vote per share under certain circumstances.

Where an event has occurred that triggers a change in the conversion ratio, the number of votes that the investors' shares will carry for any subsequent general shareholder vote will often be automatically adjusted to reflect the change in the conversion ratio at the time of the vote.

### 15. Protective provisions and consent rights (class rights)

The venture capital investors in an investment round normally require that certain actions cannot be taken by the company without the consent of the holders of a majority (or other specific percentage) of their class or series of shares (investor majority). Sometimes these consent rights are split between consent of an investor majority (usually being decisions which typically require shareholder approval) and those requiring consent of the investor director(s) (being decisions which are typically board decisions).



The purpose of these rights is to protect the investors from the company taking actions which may adversely affect the value of their investment. The types of actions covered include (among many others): changes to share classes and share rights, changes to the company's capital structure, issuance of new shares, mergers and acquisitions, the sale of major assets, winding up or liquidating the company, declaring dividends, incurring debts above a certain amount, appointing key members of the management team and materially changing or departing from the company's business plan. These shareholder rights are particularly important for investors who do not appoint a director to the Board of Directors (see section 16 below).

Alongside these consent rights, there are usually various undertakings or covenants given by the company, or sometimes the founders, to do certain acts. Typically these include taking steps to protect intellectual property, applying investment monies in accordance with the business plan and maintaining appropriate insurance. Other types of covenants are described in the sections below headed *Information Rights* (see section 17 below) and Confidentiality, Intellectual Property Assignment and Management Non-compete Agreements (see section 20 below).

## **16. Board of Directors/Board Observer**

Venture capital investors require that the company has an appropriate Board of Directors. Although a majority of non-executive directors may be impractical for small companies, it is usual for such companies to have at least one or two non-executives. One or more of the non-executive directors will be appointed by the investors under rights granted to them in the investment documentation. Some investors will never appoint a director, because of potential conflicts of interest and liability issues, and will instead require the right to appoint a Board observer. A board observer can attend all board meetings but will not participate in any board decisions. The Board of Directors tends to meet monthly (in addition to any meeting required for special business), particularly for early stage companies with active investors on the Board.

In many cases, investors will require that the Board has a *Remuneration or Compensation Committee* to decide on compensation for company executives, including share option grants (see section 21 below), as well as an *Audit Committee* to oversee financial reporting. These committees will be made up entirely with, or have a majority of, non-executive directors and will include the directors appointed by the investors. Each of these committees should have its own mandate (usually set out in writing in the Investment Agreement).

## **17. Information rights**

In order for venture capital investors to monitor the condition of their investment, it is essential that the company provides them with certain regular updates concerning its financial condition and budgets, as well as a general right to visit the company and examine its books and records. This sometimes includes direct access to the company's auditors and bankers. These contractually defined obligations typically include timely transmittal of annual financial statements (including audit requirements, if applicable), annual budgets, and audited monthly and quarterly financial statements.

## **18. Exit**



Venture capital investors want to see a path from their investment in the company leading to an exit, most often in the form of a disposal of their shares following an IPO or by participating in a sale. Sometimes the threshold for a liquidity event (see section 4 above) or conversion (see section 6 above) will be a qualified exit. If used, it will mean that a liquidity event will only occur, and conversion of preferred shares will only be compulsory, if an IPO falls within the definition of a qualified exit. A qualified exit is usually defined as a sale or IPO on a recognised investment exchange which, in either case, is of a certain value to ensure the investors get a minimum return on their investment.

Consequently, investors usually require undertakings from the company and other shareholders that they will endeavour to achieve an appropriate share *listing* or *trade sale* within a limited period of time (typically anywhere between 3 and 7 years depending on the stage of investment and the maturity of the company). If such an exit is not achieved, investors often build in structures which will allow them to withdraw some or all of the amount of their investment (see section 5 above).

## **19. Registration rights (US)**

Registration rights are a US securities law concept that is alien to many companies and investors. Such rights are needed because securities can only be offered for public sale in the US (with certain exceptions) if they have first been registered with the Securities and Exchange Commission (SEC). The registration process involves the company whose shares are to be offered providing significant amounts of information about its operations and financial condition, which can be time consuming and costly.

Unlike in New Zealand, where all of a company's shares usually become tradable upon a public listing, a company registering shares to be traded in the US is not required to register all of its issued shares. Any shares that are left unregistered can only be traded under very restricted circumstances, which can greatly diminish their value. Consequently, investors in the US or in companies which may consider pursuing a listing in the US, usually require the company to enter into a Registration Rights Agreement. Among other things, this gives the investors rights to demand registration of their shares (*demand rights*) and to have their shares registered along with any other shares of the company being registered (*piggy-back rights*) and allocates costs and potential liabilities associated with the registration process.

## **20. Confidentiality, Intellectual Property Assignment and Management Non-compete Agreements**

It is good practice for any company to have certain types of agreements in place with its employees. For technology start-ups, these generally include Confidentiality Agreements (to protect against loss of company *trade secrets*, know-how, customer lists, and other potentially sensitive information), Intellectual Property Assignment Agreements (to ensure that intellectual property developed by academic institutions or by employees before they were employed by the company will belong to the company) and Employment Contracts or Consultancy Agreements (which will include provisions to ensure that all intellectual property developed by a company's employees belongs to the company). Where the company is a spin-out from an academic institution, the founders will frequently be consultants of the company and continue to be employees of the academic institution, at least until the company is more established.

Investors also seek to have key founders and managers enter into Non-compete Agreements with the company. In most cases, the investment in the company is based largely on the value of the technology and management experience of the management team and founders. If they were to leave the company to create or work for a competitor, this could significantly affect the company's value. Investors normally require that these agreements be included in the Investment Agreement as well as in the Employment/Consultancy Agreements with the founders and senior managers, to enable them to have a right of direct action against the founders and managers if the restrictions are breached.

## **21. Employee share option plan**

An employee share option plan (ESOP) is a plan that reserves and allocates a percentage of the shares of the company for share option grants to current and future employees of the company (and certain other individuals) at the discretion of a management or remuneration committee or the Board. The intention is to provide an incentive for the employees by allowing them to share in the financial rewards resulting from the success of the company. Investors typically want 10% to 20% of the share capital of the company to be reserved in an ESOP creating an option pool. The company will then be able to issue the shares under the plan without requiring further approval from the investors.

## **22. Transaction and monitoring fees**

Venture capital investors are usually paid a fee by the company to cover internal and external costs incurred in connection with the investment process. In some jurisdictions this might constitute illegal financial assistance. Some investors may require an annual monitoring fee to compensate for the level of their involvement with the investee company, in addition to any compensation for travel and out-of-pocket expenses in relation to board participation.

## **23. Confidentiality**

Exchanges of confidential information between potential venture capital investors and the company will usually be subject to confidentiality. The confidentiality obligations may already be comprised in an agreement executed prior to discussions with the company about a potential investment.

## 24. Exclusivity and Break Fees

Once a Term Sheet is signed, venture capital investors will undertake various types of *due diligence* on the company (any or all of technical, commercial, legal and financial). They will usually provide the company with a list of areas which they would like to cover and information which they would like to receive. The process can take several weeks or even months and the investors may also use third party advisors to assist them in the process (e.g. lawyers, accountants and relevant technology experts). This will involve expense and the investors will not want to discover that while they are incurring this expense the company accepts investment from other investors. To protect themselves, some investors will ask for an exclusivity period during which the company is prohibited from seeking investment from any third parties. A breach of this obligation will result in the company and founders incurring a financial penalty. In addition the investors may require a *Break Fee* if the company declines their investment (which it generally can do where the investment provisions in the Term Sheet are not binding – see next section).

## 25. Enforceability

With the exception of clauses dealing with confidentiality, transaction fees, exclusivity and break fees, the provisions of a signed Term Sheet will not usually be legally binding.

## 26. Conditions precedent

A full list of conditions to be satisfied before investment will be included in the Term Sheet. A venture capital investment will usually be conditional on not only the negotiation of definitive legal documents, but the satisfactory completion of due diligence and approval by the Investment Committee of each of the venture capital investors.

Satisfactory completion of due diligence can include conclusion of commercial, scientific and intellectual property due diligence, a review of current trading and forecasts, a review of existing and proposed management service contracts, a review of the company's financial history and current financial position, either a full legal review or one targeted on specific areas. It is also common for investors to require the founders and senior management to sign up to Employment or Consultancy Agreements in a form approved by the investors.

# V Venture Capital Glossary of Terms

### *Angels*

High net worth individuals who provide seed money to very early stage companies, usually investing their own money rather than that of institutional or other investors.

### *Anti-dilution provisions*

Provisions which protect the holder's investment from dilution as the result of later issues of shares at a lower price than the investor paid by adjusting the option price or conversion ratio or issuing new shares (see section 8, Part IV above).

### *As converted basis*

The determination of preferred shares rights, such as vesting and participation in a dividend, on the basis that those shares have been converted into ordinary shares, taking account of whatever adjustments might be necessary.

*Audit Committee*

A committee of the Board of Directors consisting of a majority of *independent (non-executive) directors*, responsible for selecting and overseeing the work of outside auditors and other audit activities. The definition of an independent director may vary from one market to another (see section 16, Part IV above).

*Break Fee*

A fee typically payable to the investor if the company declines the investment described in the Term Sheet or if the company or founders breach exclusivity or other binding provisions in the Term Sheet.

*Bridge loan, bridge finance or bridge round*

A loan or *equity* investment to provide financing for a relatively short time period until the issuer can complete a longer term financing such as a public offering or new investment round.

*Burn rate*

The rate at which a company is consuming cash each month.

*Capitalise*

Converting a debt owed to a company into equity (see section 3, Part IV above).

*Capitalisation table (cap table)*

A spreadsheet listing all shareholders and holders of shares, options and any other securities, along with the number of shares, options and convertible securities held (see Box 1 and Box 2 in Part III above).

*Carried interest*

The portion of any profits realised by a venture capital fund to which the fund managers are entitled, in addition to any returns generated by capital invested by the fund managers. Carried interest payments are customary in the venture capital industry. Also known as the 'carry'.

*Completion or closing*

In the context of a venture capital investment round, the release of investment funds to the company and the issuance of shares to the investors following execution of the investment documents and verification that all necessary conditions have been fulfilled.

*Co-investment*

See *Syndication*.

*Conversion*

The act of exchanging one form of security for another security of the same company, e.g. preferred shares for ordinary shares, debt securities for equity (see section 6, Part IV above).

*Conversion ratio*

The ratio indicating the number of underlying securities that can be acquired upon exchange of a convertible security, e.g. the number of ordinary shares into which preferred shares are convertible (see section 6, Part IV above).

*Convertible debt*

A debt obligation of a company which is convertible into shares.

*Convertible preferred shares*

Preferred shares convertible into ordinary shares.

*Covenants*

Undertakings given to the investors by the company and sometimes the founders to do or not do certain acts (see section 15, Part IV above).

*Cumulative dividends*

A dividend which accumulates if not paid in the period when due and must be paid in full before other dividends are paid on the company's ordinary shares (see section 3, Part IV above).

*Cumulative preferred shares*

A form of preferred shares which provides that if one or more dividends are omitted, those dividends accumulate and must be paid in full before other dividends may be paid on the company's ordinary shares (see section 3, Part IV above).

*Debt/equity ratio*

A measure of a company's leverage, calculated by dividing long-term debt by ordinary shareholders' equity.

*Debt financing*

Financing by selling notes or other debt instruments.

*Deed of accession*

An agreement that purchasers of shares (new or existing) may be required to sign to ensure they are bound by the terms of an Investment Agreement.

*Deemed liquidation or liquidity event*

Term used to describe trigger events for a liquidation preference. Usually defined to cover, among other things, a merger, acquisition, change of control or consolidation of the company, or a sale of all or most of its assets (see section 4, Part IV above).

*Default*

Failure to discharge a contractual obligation, e.g. to pay interest or principal on a debt when due.

*Demand registration rights (US)*

The contractual right of a security holder to require an issuer to file a registration statement to register the holder's securities so that the holder may sell them in the public market without restriction (see section 19, Part IV above).

*Dilution*

The process by which an investor's percentage holding of shares in a company is reduced by the issuance of new securities (see section 8, Part IV above).

*Directors & officers insurance*

Directors and officers (D&O) insurance is professional liability coverage for legal expenses and liability to shareholders, creditors or others caused by actions or omissions by a director or officer of a company.

*Disclosure letter*

A letter given by the founders, and maybe other key members of the management team, and the company, to the investors setting out exceptions to the representations and warranties.

*Discounted cash flow (DCF)*

An investment appraisal technique which takes into account both the time value of money and also the total profitability of a project over a project's life.

*Divestment*

The disposal of a business or business segment.

*Dividends*

When a company makes a profit, it can pay part of these profits to its shareholders in the form of cash, additional shares or other assets. Such payments are known as dividends (see section 3, Part IV above).

*Down round*

A round of venture capital financing in which the valuation of the company is less than the previous round (see section 8, Part IV above).

*Drag along/bring along*

A mechanism ensuring that if a specified percentage of shareholders agree to sell their shares, they can compel the others to sell ensuring that a prospective purchaser can acquire 100% of a company (see section 12, Part IV above).

*Due diligence*

The process of researching a business and its management prior to deciding whether to proceed with an investment in a company (see section 24, Part IV above).

*Early stage capital*

Finance for companies to initiate commercial manufacturing and sales, following receipt of seed capital.

*Earnings*

Profits after expenses.

*EBIT/EBITDA*

Earnings before interest and taxes/earnings before interest, taxes, depreciation and amortisation (financial measurements often used in valuing a company).

*Employee share option plan (ESOP)*

A scheme to enable employees to acquire shares in the companies in which they work (see section 21, Part IV above).

*Equity*

Ownership interest in a company represented by shares.

*Exclusivity Agreement*

An agreed period of exclusivity during which the company and/or its existing shareholders cannot negotiate with others for investment into the company.

*Exercise price*

The price at which an option or *warrant* can be exercised.

*Exit mechanism*

Term used to describe the method by which a venture capitalist will eventually sell out of an investment (see section 18, Part IV above).

*Exit strategy*

Potential scenarios for liquidating an investment while achieving the maximum possible return. For venture capital-backed companies, typical exit strategies include Initial Public Offerings (IPOs) and acquisitions by, or mergers with, larger companies (see section 18, Part IV above).

*Flotation*

To obtain a listing or IPO on a stock exchange (see section 18, Part IV above).

*Follow-on investment round*

An additional investment by existing and/or new investors, which may be provided for in documentation relating to the initial investment.

*Founder shares*

Shares issued to the founders of a company, usually at a low price by comparison to that paid by investors (see section 9, Part IV above). See also *Sweat equity*.

*Full ratchet*

Anti-dilution provisions that apply the lowest sale price for any ordinary shares (or equivalents) sold by the company after the issuing of an option or convertible share as being the adjusted option price or conversion price for those options or shares (see section 8, Part IV above).



*Fully diluted share capital*

The issued share capital of a company if all options and other rights to subscribe for shares are exercised.

*Fully participating*

Term sometimes used to describe a liquidation preference which entitles beneficiaries to receive a priority initial fixed payment and share pro rata with other share classes in any remaining proceeds (see section 4, Part IV above).

*Generally accepted accounting principles (GAAP)*

Accounting principles, rules and procedures generally accepted within the accounting profession.

*Good leaver/bad leaver*

A criteria applied to a shareholder employee who is ceasing to be employed to determine whether his shares should be subject to a compulsory sale, and if so, at what price (see section 9, Part IV above).

*Independent or outside director*

A non-executive member of the Board of Directors who is not an employee of a company nor affiliated with a controlling stockholder of a company. The definition of independent may be further defined in different countries or markets (see section 16, Part IV above).

*Information rights*

The contractual right to obtain information about a company, attend board meetings, etc. typically received by venture capitalists investing in privately held companies (see section 17, Part IV above).

*Initial public offering (IPO)*

The sale of shares to the public by a company for the first time. Prior to an IPO, companies that sell shares to investors are considered privately held. This is the first time that a company has tried to raise funds on a public market such as a stock exchange. Terms used to describe this are flotation, float, going public, listing when a company obtains a quotation on a stock market (see section 4, Part IV above).

*Institutional investor*

An organisation whose primary purpose is to invest assets owned by the organisation or entrusted to them by others. Typical institutional investors are banks, pension funds, insurance companies, mutual funds and university endowments.

*Intangibles*

The non-physical assets of a company that have a value, e.g. intellectual property rights including trademarks and *patents*.

*Intellectual property (IP)*

Legal term used to describe the patents, licences, copyrights, trade marks and designs owned by a company (see Part III above).

*Internal rate of return (IRR)*

An accounting term for the rate of return on an asset. It is defined as the interest rate that equates the present value of future returns to the initial investment. It is greatly affected by the timing of the exit.

#### *Investment Agreement*

This is a summary of the main terms of the investment into the company. Typically it will describe the amounts and types of shares to be issued and the specific rights of the investors such as veto rights and information rights (see Investment Agreements in Part II above).

#### *Key man insurance*

Insurance obtained by the Company on the lives of key employees, usually the chief executive officer and the person or persons ultimately responsible for continuing to develop the technology (see section 26, Part IV above).

#### *Lead investor*

In a substantial investment, the whole risk is often shared among a syndicate. Normally, one investor (the lead investor) will take the lead in negotiating the terms of the investment and managing due diligence (see Syndication below).

#### *Licence Agreement*

An agreement under which certain commercial and/or intellectual property rights may be used by the licensee, for example the institution may licence intellectual property rights to the investee company.

#### *Liquidation or winding up*

The sale of all of a company's assets, for distribution to creditors and shareholders in order of priority. This may be as a result of the insolvency of the company or by agreement amongst shareholders (see section 4, Part IV above).

#### *Liquidation preference*

A negotiated term of a round of venture capital financing that calls for certain investors to have all or most of their entire investment repaid (or a multiple of the entire investment) if the company is liquidated in priority to shareholders holding other share classes. Often also triggered by a deemed liquidation (see section 4, Part IV above).

#### *Liquidity*

Ability to convert an asset (such as shares) to cash (see section 7, Part IV above).

#### *Listing*

When a company's shares are traded on a stock market it is said to be listed (see section 18, Part IV above).

#### *Lock-up*

A provision in the Underwriting Agreement between an investment bank and existing shareholders that prohibits corporate insiders, private equity investors and possibly other large shareholders, from selling for a certain period of time following a public offering.

#### *Milestone*

A contractual target that must be met by the company. Often used by investors as a condition for releasing further amounts of financing (see section 2, Part IV above).

*Net present value (NPV)*

The current value of future cash flows discounted back to today's date using a stated discount rate.

*NewCo*

Word often used to describe a newly formed investee company (see Part III above).

*New money*

Investment funds coming from an investor who is not a current shareholder of the company.

*Non-executive director*

Part-time directors who share all the legal responsibilities of their executive colleagues on the board of a company. An investor will often appoint a non-executive to a board as one way of monitoring its investment (see section 16, Part IV above).

*Non-qualified IPO*

An IPO which is not a qualified IPO.

*Options*

The right, but not the obligation, to buy or sell a security at a set price (which may be set by a formula related to performance) in a given period.

*Ordinary shares*

These are equity shares that are entitled to all income and capital after the rights of all other classes of capital and creditors have been satisfied.

*Outside director*

See Independent or outside director.

*Pari passu*

Equally, rateably, without preference. Generally used to describe securities which are to be treated as being of equal priority or preference.

*Participating preferred shares*

Preferred shares which entitle the holder not only to its stated dividend and liquidation preference, but also allows the holder to participate in dividends and liquidation distributions declared on ordinary shares.

*Patent*

The exclusive right (conferred by acceptance of registration) to make, use or sell an invention or a process for a specific period of time.

*Pay to play*

A provision which requires investors to participate in subsequent rounds or forfeit certain rights such as anti-dilution.

*Piggy-back registration rights (US)*

Contractual rights granted to security holders giving them the right to have their holdings included in a registration statement if and when the issuer files a registration statement (see section 19, Part IV above).

*Post-money valuation*

The value of a privately held company immediately after the most recent round of financing. This value is calculated by multiplying the company's total (fully diluted) number of shares by the share price of the latest financing (see section 2, Part IV above).

*Pre-emption right*

The right of an investor to participate in a financing to the extent necessary to ensure that, if exercised, its percentage ownership of the company's securities will remain the same after the financing as it was before. Sometimes also used as a term for a right of first refusal on shares of other investors (see section 10, Part IV above).

#### *Preferred ordinary shares*

These may be known as A ordinary shares, cumulative convertible participating preferred ordinary shares or cumulative preferred ordinary shares. These are equity shares with preferred rights. Typically they will rank ahead of the ordinary shares for income and capital. Once the preferred ordinary share capital has been repaid, the two classes may then rank pari passu in sharing any surplus capital. Their income rights may be defined; they may be entitled to a fixed dividend (a percentage linked to the subscription price, e.g. [•]% fixed) and/or they may have a right to a defined share of the company profits – known as a participating dividend (e.g. [•]% of profits before tax).

#### *Pre-money valuation*

The value of a privately held company prior to the most recent round of financing (see section 2, Part IV above).

#### *Put option*

A contract whereby the holder of the option has the right to sell to the grantor shares at a specific price (strike price) at some time in the future.

#### *Qualified IPO*

An IPO which gives the company a market capitalisation of at least a certain amount (often a multiple of the valuation at the time of an investment) and is accompanied by a fully underwritten fund raising of a certain amount (see section 7, Part IV above).

#### *Recapitalisation*

The reorganisation of a company's capital structure by the infusion of new cash and/or the replacement of current shareholders by new ones. Recapitalisation can be an alternative exit strategy for venture capitalists.

#### *Ratchets*

A structure whereby the eventual equity allocations between the groups of shareholders depend on either the future performance of the company or the rate of return achieved by the venture capital firm. This allows management shareholders to increase their stake if the company performs particularly well (see section 2, Part IV above).

#### *Redeemable shares*

Shares which the company can be made to repurchase or which the company has the right to repurchase at a predetermined value (see section 5, Part IV above).

#### *Registration rights (US)*

The contractual right of a shareholder to participate in the registration of the issuer's stock for resale in the public market (see section 19, Part IV above).

#### *Remuneration Committee or Compensation Committee*

A committee of the Board of Directors responsible for reviewing and setting the remuneration of certain executive officers of the company. The Remuneration Committee may also be responsible for the allocation of share options to employees.

A Remuneration Committee is typically comprised of a majority of independent directors of the company (see section 16, Part IV above).

*Representations and warranties*

Terms in an Investment or Subscription Agreement whereby usually the founders and key managers and (subject to local company law) the company give undertakings in respect of the past and present operating condition of a company. Breach of warranty gives the investors the right to claim damages and, if it is sufficiently fundamental, may enable the investors to terminate the contract (see section 13, Part IV above).

*Restrictive covenants/non-competes*

Undertakings given by founders/key management in the Investment Agreement and contracts of employment or consultancy agreements which restrict their ability to undertake activities which might compete with the company both during their employment/consultancy and post termination of employment or consultancy in order to protect the business and the value of the company (see section 20, Part IV above).

*Right of first refusal (ROFR)*

A contractual right, frequently granted to venture capitalists, to purchase shares held by other shareholders before such shares may be sold to a third party (see section 11, Part IV above).

*ROI*

Return on investment (see section 3, Part IV above).

*Secured debt/loan*

Loan, where the lender, in the event of a failure to meet either an interest or principal payment, has rights to sell specific assets and recover the amount in default from the proceeds of sale.

*Seed capital*

Capital provided to allow a business concept to be developed, perhaps involving the production of a business plan, prototypes and additional research, prior to bringing a product to market and commercial large-scale manufacturing (see Part I above).

*Series*

A round of venture capital financing. Each sequential round is distinguished by a letter: A, B, C, etc. (see section 1, Part IV above).

*Shareholders' Agreement/Investor Rights Agreement*

Many of the rights between shareholders in a company are set out in its Constitution. This is a public document that is filed at the Companies Office. In many cases shareholders will want to create rights and obligations between them that they would prefer to keep confidential. In such cases, rather than put those rights and obligations into a public document they will enter into private contractual arrangements, in a document such as a Shareholders' Agreement. If the agreement also includes terms relating to the subscription for shares it will often be referred to as the Investment Agreement (see Part II above).

*Share option*

An agreement providing for the purchase or sale of shares within a stipulated time and for a certain price (see section 21, Part IV above).

*Subscription Agreement*



A Subscription Agreement sets out the terms upon which an investor will subscribe for shares in a company. If the agreement also includes terms relating to shareholders' rights it may also be described as an Investment Agreement (see Part II above).

#### *Sweat equity*

Equity (shares in a company) which is given to the founder of the company in recognition of the effort (sweat) which he has expended in getting the company started up (see Part III and section 9, Part IV above).

#### *Syndication*

An arrangement whereby a group of investors come together to invest in an investment proposition. A syndicate is usually lead by a lead investor.

#### *Tag along rights*

A mechanism to ensure that if one investor or founder has an opportunity to sell shares the other shareholders are also given that opportunity on a proportionate basis (see section 11, Part IV above).

#### *Trade sale*

Sale of a company to another company. As a form of exit, it is an alternative to flotation and more common (see section 18, Part IV above).

#### *Trade secret*

Information, such as a formula, pattern, device, or process, that is not known to the public and which gives the person possessing the information a competitive advantage. May sometimes include customer lists, marketing and/or business plans, and details of suppliers and customers.

#### *Tranching*

Investment made in stages, each stage being dependent on achievement of targets or milestones (see section 2, Part IV above).

#### *Transfer restrictions*

Restriction on the sale of shares by founders, management or investors for a predefined period of time or until certain conditions have been fulfilled (see section 11, Part IV above).

#### *Use of proceeds*

The purpose to which the company intends to use the funds raised from new investors. The investment documentation often stipulates that the funds must be used for this purpose.

#### *Vesting*

Where an employee or consultant has been granted rights to receive options or has been issued shares which are subject to his completing a specific length of service or achieving certain milestones, the options or shares will have vested when the period or milestone has been satisfied. Once vested the employee or consultant is entitled to exercise those options to obtain shares or to receive full rights to the shares (see section 9, Part IV above).

#### *Warrant*

Another term for an option to purchase a security. The term is generally used for options provided by the company to outside investors (as distinct from officers, employees, etc.).

*Weighted average*

Anti-dilution provisions that apply a weighted average formula to adjust the number of shares held, option price or conversion ratio of an early-round investor, based on the sale price and number of equivalent shares sold by the company after the issuing of the share options or convertible securities (see section 8, Part IV above).

## VI Example of a Term Sheet for a Series A round

Strictly private and confidential  
Not to be disclosed or distributed to third parties

Draft

### Indicative Term Sheet [For use for Series A round]

We are pleased to present our proposal for an investment in ..... (the "Company").

#### 1. Investment

- 1.1 You have told us that the proposed business plan for the Company calls for an equity injection of \$[•]. Of this amount, funds managed by us (the "Funds") will provide \$[•] alongside investment by other venture capital funds or financial institutions (together the "Investors"). We will act as lead equity investor.
- 1.2 The investment will be at a fully diluted pre-money valuation of \$[•], including employee share options (both granted or committed) equal to [•]% of the fully diluted equity. This represents a [•]% shareholding for the Investors on a fully diluted basis, following an expansion of the share option pool as detailed in paragraph 2.4. The current capitalisation of the Company is set out in Part I of Appendix 1 and the capitalisation of the Company after this proposed funding is set out in Part 2 of Appendix 1. (*See section 2, Part IV above.*)
- 1.3 The investment will be made in the form of convertible participating [redeemable] preferred shares ("Preferred Shares") at a price of \$[•] per Preferred Share (the "Original Issue Price") the terms of which are set out in Appendix 2.
- 1.4 [The investment will be made in full at completion.]  
  
[The investment will be staged with [•]% being invested at completion (the "First Tranche") and [•]% being invested subsequently ("Subsequent Tranches"). [The Investors will have the right, but not the obligation, to subscribe for Subsequent Tranches at the same price per share as the First Tranche at [any time.][the dates and amounts specified in Appendix [ ]][In addition, provided that the performance milestones referred to in paragraph 2.5 have been met, the Board of Directors of the Company (the "Board") will have the right to call Subsequent Tranches within [•] months of a performance milestone being satisfied.] (*See section 2, Part IV above.*)
- 1.5 The proceeds from the investment must be used for the Company's working capital requirements to achieve the business plan [attached in Appendix [ ] ] [to be agreed pursuant to Clause 2].[ ]].

## 2. Conditions of investment

- 2.1** The investment is conditional on negotiation of definitive legal documents, satisfactory completion of due diligence approval by our Investment Committee and the conditions in clauses 2.3 to 2. [ ] (See section 26, Part IV above.)
- 2.2** Satisfactory completion of due diligence will include our satisfaction with:
- (a) Conclusion of our commercial due diligence [including [•]];
  - (b) References from customers and partners;
  - (c) Market and technology review by [an independent third party];
  - (d) Management references;
  - (e) Review of current trading and forecasts for the next [•] months;
  - (f) Review of existing and/or proposed management service contracts;
  - (g) Review of the Company's financial history and current financial situation by our advisors including, a review of the last set of audited accounts and the latest set of monthly management accounts prior to completion of our investment; and
  - (h) Full legal review of the Company by our lawyers, focusing particularly on ownership of all necessary intellectual property and benefit of all key commercial contracts.
- 2.3** [The Company must secure institutional co-investment of at least \$[•] on identical terms or other terms acceptable to us from other venture capital funds or similar organisations acceptable to us. We will not underwrite the total funding sought nor guarantee the securing of co-investors.]
- 2.4** [The share option pool must be expanded prior to the investment to represent [•]% of the equity on a fully diluted basis. These extra share options will be reserved for new employees and will have an exercise price equal to the Original Issue Price (see paragraph 1.3) [or may be exercised at a discount to that price subject to consent from the relevant tax authority and the Investor Director (see paragraph 4.3)]. Following grant, these options will vest quarterly over a [•] year period, [subject to a minimum employment of [•] year]. (See section 21, Part IV above.)
- 2.5** [Appendix 7 sets out the performance milestones which must be satisfied within the periods stated before Subsequent Tranches can be called.] (See section 2, Part IV above.)
- 2.6, 2.7 etc [Other Conditions]**

## 3. Founder Shares

- 3.1** The Founders (being *[insert names of founders]*), will hold A Ordinary Shares ("Founder Shares") [which will be purchased for \$[•] per share]. [The Founder Shares will be subject to [vesting rights] [and good leaver/bad leaver provisions] as summarised in Appendix 3.] (See section 9, Part IV above.)

#### **4. Terms of Investment**

- 4.1** The Company and the Founders will provide the Investors with customary representations and warranties (examples of which are set out in Appendix 4) and the Founders will provide the Investors with customary non-competition, non-solicitation and confidentiality undertakings. (See section 9, Part IV above.)
- 4.2** The Board will have a maximum of [•] directors. [For so long as the Investors hold (or will hold when they have subscribed for all the shares contemplated by this Term Sheet) [•]% of the issued share capital of the Company on an as converted basis] the Investors will have the right to appoint [one] [two] director(s) (the "Investor Director(s)"). The composition of the Board on completion will be [•]. There will be a minimum of [ ] board meetings each year. (See section 16, Part IV above.)
- 4.3** The Investor's or the Investor Director's consent will be required for certain key decisions, examples of which are set out in Appendix 5. (See section 16, Part IV above.)
- 4.4** [The Investors will also have at all times the right to designate a non-voting observer to the Board.]. (See section 16, Part IV above.)
- 4.5** The Company will form a Remuneration Committee [and an Audit Committee] upon completion and the Investor Director will be the chairman [of both]. (See section 16, Part IV above.)
- 4.6** The Company will have an obligation to supply normal financial and operational information about the Company to the Investors. (See section 17, Part IV above.)
- 4.7** The Investors and the Founders will have rights to acquire and sell shares as outlined in Appendix 6. (See sections 10, 11 and 12, Part IV above.)
- 4.8** [If the Company is floated on a US market, registrable securities will include all Preferred Shares, or any shares issuable on their conversion and any other shares held by the Investors. The Investors will be given full registration rights customary in transactions of this type (including [•] demand rights, unlimited piggy-back rights and [•] S3 registration rights), with the expenses paid by the Company.] (See section 19, Part IV above.)
- 4.9** The key members of the management team will be required to sign service agreements which include customary provisions for non-disclosure, non-competition, non-solicitation, confidentiality, assignment of intellectual property rights, and termination. (See section 20, Part IV above.)
- 4.10** [Within [•] months of completion,] [Before completion,] the Company must obtain key man insurance, naming the Company as beneficiary on the lives of [•] and [•] for an amount of \$[•] and director and officer liability insurance, both in a form acceptable to the Investors.

**4.11** The Company will agree to pay to the investors an annual, index-linked advisory fee of \$[•] per annum plus GST, charged quarterly in advance, plus reasonable out of pocket expenses in respect of each Investor Director. (See section 22, Part IV above.)

**4.12** [The Investors' investment appraisal and legal costs will be borne by the Company [up to a maximum of \$ [ ]. In addition, on completion, the Company will pay to us a transaction fee of \$[•] plus GST.] [The Company and the Investors will bear their own costs in relation to the investment, save that the Company will contribute an aggregate of \$[•] to the expenses of the Investors.] (See section 22, Part IV above.)

## **5. Confidentiality**

**5.1** This Term Sheet is written on the basis that its contents and existence are confidential and will not (except with our agreement in writing or in order to comply with any statutory or stock exchange or other regulatory requirements) be revealed by the Investors or the Founders to any third Party or be the subject of any announcement. (See section 23, Part IV above.)

**5.2** The Investors and the Founders agree that they will enter into a non-disclosure agreement before the Investors begin their due diligence investigations.

## **6. Applicable law**

**6.1** This letter is governed by New Zealand law and on acceptance the parties submit to the non-exclusive jurisdiction of the courts of New Zealand.

## **7. Expiry date**

**7.1** The Founders and the Company are requested to confirm their acceptance of the terms of our proposal within [ ] days of the date of this letter, failing which our proposal will lapse.

## **8. Exclusivity**

**8.1** In consideration of the Investors expending time and professional and other fees (the "Costs") in progressing this offer the Founders and the Company agree and undertake that they will not directly or indirectly until the earlier of the expiry of [•] days from the date of acceptance of the terms of this proposal or the date that the Investors notify the Company of their intention not to proceed with this proposal (the "Period") solicit, directly or indirectly, further offers for the purchase and/or subscription of shares in the Company (or any part thereof) or any material part of the business, assets or undertakings of the Company or enter into or continue to seek negotiations with any party other than the Investors in connection with such matters. (See section 24, Part IV above.)

The Founders and the Company agree and undertake to inform the Investors immediately of the identity of any third party who contacts the Founders or the Company with a view to the sale of any interest in the shares of the Company or any part of the business of the Company.

[By accepting this offer the Founders and the Company confirm that if:

- (a) they withdraw from negotiating in good faith with the Investors during the Period to conclude definitive agreements to document the investment(s) contemplated by this Term Sheet; or
- (b) if they breach the exclusivity provisions in this paragraph 8]; or if the Investors decide not to proceed with this offer due to a materially adverse fact or circumstance [which exists today but] of which the Investors become aware during this Period, then the Company and the Founders undertake to pay to the Investors:
  - (i) the sum of \$[•] (such sum being a genuine pre-estimate of the loss to the Investors in the event that this offer does not proceed); and
  - (ii) to the extent not recovered under paragraph (i) above the Costs incurred by the Investors in relation to this proposal;

provided that under no circumstances shall the Company and the Founders be obliged to pay the Investors more than \$[•] under this paragraph 8].

Each of the undertakings referred to in this paragraph 8 shall be read and construed independently so that if any undertaking is held to be invalid or unenforceable for any reason the remaining undertakings shall continue to apply.

## 9. No intention to create legal relations

Except for the provisions of each of paragraphs [5 to 10], which are intended to create legally binding obligations between the parties, this Term Sheet sets out indicative terms on which we would be prepared to make an investment in the Company and will not give rise to any contract between us. (*See section 25, Part IV above.*)

## 10. Exclusion of representations and warranties

By accepting this proposal you acknowledge that you have not relied on any representation or warranty on our part or entered into any other agreement with us in connection with the provision of funding by the Investors.

To confirm your acceptance of the terms of this proposal please sign and date the duplicate copy of this Term Sheet and return it to us.

[On copy]

To: [INSERT NAME OF INVESTOR]

We hereby acknowledge and accept the terms of the above Term Sheet. We confirm that we grant you a [•] day period of exclusivity from the date of acceptance and that in the event that we subsequently withdraw from the transaction, in accordance with paragraph 8 of the Term Sheet, we will reimburse to you on demand a sum equal to all the external professional costs and expenses incurred by you up to the date of our withdrawal. (*See section 25, Part IV above.*)



Signed by [ \_\_\_\_\_ ]  
for and on behalf of [ \_\_\_\_\_ ]

\_\_\_\_\_ Date

\_\_\_\_\_ [Founder]

\_\_\_\_\_ Date

\_\_\_\_\_ [Founder]

\_\_\_\_\_ Date

\_\_\_\_\_ [Founder]

\_\_\_\_\_ Date

## **Appendix 1**

### **Capitalisation table**

#### **Part 1**

[current capitalisation]

#### **Part 2**

[post funding capitalisation]

## Appendix 2

### Rights attaching to Preferred Shares

1. The price per Preferred Share will be \$[•] [determined before completion] (the "Original Issue Price"). (See section 2, Part IV above.)
2. The Preferred Shares will have a preferential cumulative coupon of [•]% per annum [starting on [•] 200[•]]. Any other dividends or distributions will be payable to all shareholders on a pro rata basis (in the case of the holders of Preferred Shares, determined on an as converted basis). (See section 3, Part IV above.)
3. Upon liquidation of the Company, the Preferred Shareholders will receive in preference to all other shareholders an amount in respect of each Preferred Share equal to [[•] times] the Original Issue Price (the "Liquidation Preference") (after adjusting for any Recapitalisation Events) (see paragraph 5), plus all accrued but unpaid dividends. The Founders and Ordinary Shareholders will also be entitled to recover an amount per Ordinary Share equal to the amount paid up on those Ordinary Shares. To the extent that the Company has assets remaining after the distribution of that amount, the Preferred Shareholders will participate with the Founders and Ordinary Shareholders pro rata to the number of shares held on an as converted basis. (See section 4, Part IV above.)
4. Sale of all or substantially all of the assets of the Company or a sale of shares involving a change in control (each, a "Corporate Transaction") will be treated in the same way as a liquidation [if it is not a Qualified Sale (as defined below)] and the proceeds of sale will be distributed as set out in paragraph 3. [A Qualified Sale means a sale [where the consideration payable (including any deferred consideration) exceeds \$[•]] pursuant to which Preferred Shareholders receive proceeds (in cash or marketable securities free of trading restrictions) per Preferred Share that are equal to or more than [the greater of: (i) [[•] times] the Original Issue Price, [or (ii) a price which will result in the Preferred Shareholders earning a notional [•]% rate of return on the Original Issue Price calculated daily and compounded annually].] (See section 4, Part IV above.)
5. Subject to any adjustment being made to the conversion rate following any recapitalisation, share split, consolidation or similar events (collectively "Recapitalisation Events") and/or the operation of the anti-dilution provision in paragraph 10, the Preferred Shares will be convertible at any time at the option of an Investor into an equivalent number of Ordinary Shares. (See section 6, Part IV above.)
6. The Preferred Shares will be converted automatically into Ordinary Shares, at the then applicable conversion rate:
  - 6.1 upon the completion of a firmly underwritten initial public offering ("IPO") of Ordinary Shares: (i) at a net offering price per share of at least [[•] times] the Original Issue Price (after adjusting for any Recapitalisation Events) and (ii) resulting in net aggregate proceeds to the Company of not less than \$[•] (the "Qualified IPO");
  - 6.2 when less than [•]% of the Preferred Shares issued in this financing remain outstanding;

**6.3** upon the affirmative vote of holders of more than [•]% of the outstanding Preferred Shares. (See section 7, Part IV above.)

7. An IPO [that is not a Qualified IPO] will be treated in the same way as a liquidation. The Company will issue to each holder of Preferred Shares that number (if any) of Ordinary Shares so that the proportion which the Ordinary Shares held by that shareholder bears to the fully diluted share capital following completion of all such issues and the conversion of the Preferred Shares will be equal to the proportion which the proceeds that that shareholder would have been entitled to receive on a sale on that date would bear to the valuation of the Company at that date. (See section 4, Part IV above.)
8. Immediately prior to an IPO all accrued but unpaid dividends on the Preferred Shares must be paid save to the extent that the Company decides to capitalise some or all of such amounts into Ordinary Shares. Any capitalisation will be at the price of the Ordinary Shares at IPO. (See section 3, Part IV above.)
9. The Preferred Shares will vote with Ordinary Shares on an as converted basis as a single class on all matters, other than those referred to in Appendix 5. (See sections 14 and 15, Part IV above.)
10. The Preferred Shares will have a [full ratchet]/[weighted-average] anti-dilution protection in the ease of any new issue of shares at a price below the Original Issue Price (after adjusting for any Recapitalisation Events) other than:
  - (a) shares issued pursuant to the share option pool approved by the Investors; and
  - (b) shares issued to the Investors as a result of them electing to convert their Preferred Shares into Ordinary Shares.

This anti-dilution protection will operate [so as to adjust the effective issue price of the Preferred Shares to the effective share price for the new share issue] [by the issue of additional preferred Shares at [10 cents] per share]. (See section 8, Part IV above.)

11. If the Company makes a subsequent issue of shares in which the Investors are entitled to participate and an Investor elects not to do so (i.e. does not wish to pay to play) for at least [•]% of its allocation [that Investor will lose its anti-dilution right in respect of any Preferred Shares it holds][that Investor's Preferred Shares will automatically convert into Ordinary Shares].
12. If no [Qualified] IPO or Corporate Transaction has occurred within [•] years from completion, each of the Preferred Shares will be redeemable at the option of the holder for an amount in cash equal to [the Original Purchase Price][the Liquidation Preference], plus all accrued but unpaid dividends. (See section 5, Part IV above.)
13. If no [Qualified] IPO or Corporate Transaction has occurred within [•] years from completion or redemption of the Preferred Shares cannot be completed, the [majority of] Investors [holding [•]% of the Preferred Shares], will have the right to require the Company to engage in a liquidation process by way of IPO, Corporate Transaction or liquidation. (See section 5, Part IV above.)
14. [REDEMPTION: The Company shall redeem the Preferred Shares [annually in one-third increments beginning on [•]] at a redemption price equal to the Original

Issue Price per share plus all declared but unpaid dividends (if any). The Company shall also redeem the Preferred Shares (at the same redemption price) in the event of:

- (a) a sale of substantially all the assets of the Company or
- (b) the sale of Ordinary Shares carrying in excess of 50 per cent of the voting rights in the Company at a price per Ordinary Share which (on an as converted basis) values each Preferred Share at less than the Original Issue Price. Notwithstanding either of the above,

the holders of the Preferred Shares shall receive advance notice of each redemption and shall have the option to convert any or all of the Preferred Shares otherwise due to be redeemed into Ordinary Shares prior to the mandatory redemption. In the event that the Company shall fail to make:

- (a) a mandatory redemption payment to the holders of the Preferred Shares while having funds and distributable reserves necessary to do so then the holders of the Preferred Shares shall have a majority of the votes on all matters submitted for the approval of the Company's shareholders until such defaults are rectified; or
- (b) two mandatory redemption payments to the holders of the Preferred Shares regardless of whether or not it has the funds or distributable reserves necessary to do so, then the holders of the Preferred Shares shall have the right to appoint a majority of the Board of the Directors of the Company until such default is rectified.] (See section 5, Part IV above.)

## Appendix 3

### Rights attaching to Founder Shares

1. \*Subject to paragraph 3 below, the Founder Shares will vest equally on a [quarterly/monthly] basis over a year period. (*See section 9, Part IV above.*)
2. \*If a Founder ceases to be an employee of the Company those Founder Shares which have not vested will convert into Deferred Shares. The Deferred Shares will have no right to receive a dividend, minimal rights to capital and will be non-voting. The Company will have the right to purchase back the Deferred Shares for an aggregate purchase price of [•] at any time.
3. \*If there is a Corporate Transaction at a time when any of the Founder Shares remain un-vested, the consideration may be structured in such a way that it defers realisation of the value attached to the un-vested shares until such time as they would have been vested.
4. \*If a Founder is a Bad Leaver:
  - 4.1.1 within [•] months of the start of his employment all vested shares will convert into Deferred Shares;
  - 4.1.2 after [•] months from the commencement of his employment no shares will vest during the period of [•] months before the date of his departure.

*\* Only to be used where Founders are to hold vested shares.*
5. In the event of an employee shareholder [(other than a Founder)] being a Bad Leaver all of his shares [(other than those held following the exercise of share options)] must be offered for sale at the lower of market value or the subscription price (as adjusted by any Recapitalisation) to the Company, [the employee benefit trust] and then the Investors. [If an employee shareholder [(other than a Founder)] is a Good Leaver he must similarly offer his shares for sale at the market price].
6. [Unless otherwise determined by the Board,] "Bad Leaver" means any employee shareholder [(other than a Founder)] who ceases to be employed within [•] years of completion or if later the start of his employment as a result of summary dismissal and whose dismissal is not found to have been wrongful or constructive, or who terminates his contract of employment within [•] years of completion or if later the start of his employment, other than as a result of constructive dismissal, death or permanent incapacity. "Good Leaver" means any employee shareholder [(other than a Founder)] who ceases to be employed within [•] years of completion or later start of his employment and who is not a Bad Leaver.

## Appendix 4

### Proposed warranties

The Investors will require the following items to be warranted by the Founders and the Company:

- Status of the Company
- Latest available [audited] accounts
- Management accounts covering the period from latest audited accounts to completion of the proposed investment
- Position since audited accounts date
- Business plan
- Ownership of assets and HP liabilities
- Employment contracts
- Intellectual property
- No outstanding liabilities to executives
- No litigation pending or threatened
- No breaches of existing or recent contracts
- Register of members correct/no other share issues committed
- Insurance policies up to date
- Loans/guarantees
- Taxation
- Property leasehold - terms/rights/obligations.

**The above items are not comprehensive and are only intended to provide a guide to the warranties that are likely to be included in the Investment Agreement. In particular, additional items may require warranting following due diligence. The objective of these and other warranties will be to ensure that Founders and the Company have provided the Investors with accurate information on matters upon which the Investors have based their investment decision.**

*(See section 13, Part IV above.)*



## Appendix 5

### Proposed covenants

#### 1. Investor consents

[So long as there are at least [•]% of the Preferred Shares outstanding] the prior written approval of the Investors [holding [•]% of the Preferred Shares] will be required to:

- Amend the constitution
- Change share capital
- Acquire any new business, shares or other securities
- Sell or deal with assets other than in ordinary course of business
- Wind up the Company
- Appoint or remove directors to/from the Board of the Company and any subsidiary companies.

#### 2. Board consent

The following issues to be discussed and approved by the Board including the Investor Director(s):

- Make any change of trade/business plan [(including adherence to VCT "qualifying" trade definition)]
- Declare ordinary dividends
- Adoption of share option or other incentive plans and increase in share option pool
- Approve annual budgets
- Agree any borrowings, loans, advances or credit outside the annual budget
- Create charges
- Create any subsidiaries/joint ventures
- Incur development or capital expenditure outside the annual budget
- Agree or vary the remuneration/service terms of directors of the Company and any subsidiary companies
- Acquire real estate and other real estate-related matters
- Commence or settle litigation

- Assign or license any of the intellectual property rights of the Company
- Any guarantees/indemnities other than in ordinary course of business
- Any material agreement other than in ordinary course of business
- Any change of auditor/accounting reference date/accounting policies
- Any key man insurance
- Any change of bank
- Any appointment of an employee or variation of terms where emoluments exceed \$[•].

**Materiality and other financial limits for the above to be discussed. The above items are not comprehensive and are only intended to provide a guide to the consent items that are likely to be included in the Investment Agreement.**

*(See section 15, Part IV above.)*

## Appendix 6

### Conditions of issue and transfer of shares

1. [Investors will have a right of first refusal on any new issue of shares of any class.] [Investors will have the right to participate with the holders of Founder Shares [and Ordinary Shares] in any new issue of shares of any class pro rata to their holding of shares (determined on an as converted basis).] [In addition, the Investors will have the right but not the obligation to subscribe for [%] of the next \$[.] raised by the Company in the following rounds of financing by the Company on no worse terms than offered to third party investors.] (*See section 10, Part IV above.*)
2. [Investors] [All existing shareholders] will have a right of first refusal to acquire any shares which are proposed to be transferred or sold. Investors will be able to transfer Preferred Shares freely provided that the transferee agrees to be bound by the terms of the Investment Agreement. (*See section 11, Part IV above.*)
3. For [%] years from completion no Founder Shares can be sold without the Investor's prior consent (the "Prohibition Period") [and no Founder Shares can be sold until they have vested]. (*See section 11, Part IV above.*)
4. The Investors will have tag-along rights such that if any founder has an opportunity to sell [any of his shares] [shares exceeding [%] of the issued share capital], the Investors must be given the opportunity to sell a pro rata number of their shareholding on the same terms and at the same price. (*See section 11, Part IV above.*)
5. The Investors will have co-sale rights such that if any shareholder has an opportunity to sell any or all of its shares, the effect of which would result in a change of control of the Company, the Investors must be given the opportunity to sell all of their shares on the same terms and at the same price. (*See section 11, Part IV above.*)
6. If holders of at least [%] of the Preferred Shares[, Founder Shares and Ordinary Shares] agree to sell their shares, there will be drag along rights so that all remaining shareholders and option holders will be required to sell on the same terms, provided that no Investor will be required to sell unless:
  - (a) the Investor will receive cash or marketable securities in return for its shares, and
  - (b) the Investor will not be required to provide to the purchaser representations or warranties concerning the Company (or indemnify those given by the Company or Founders) or covenants (e.g. non-compete and non-solicitation of employees). (*See section 12, Part IV above.*)

## **Appendix 7**

### **Performance milestones**

*(See section 2, Part IV above.)*