

TERM SHEET
FOR SERIES A ROUND OF FINANCING OF XCORP

Amount of
Investment: \$3,000,000

Investors: ABC Ventures
XYZ Capital

Type of Security: Series A Convertible Preferred Stock

Premoney Valuation: \$7,000,000

Capital Structure Following

Series A Round:	Existing holders of Common Stock	55%
	Option Pool	15%
	Holders of Series A Preferred Stock	30%
	Total	100%

Use of Proceeds: The Company shall use the proceeds from this financing for working capital purposes.

Dividends: The Company will not pay dividends on its shares of Common Stock or any other stock which is junior to the Series A Preferred Stock unless a like dividend is paid on all shares of Series A Preferred Stock on a pro rata "as converted" basis.

Conversion: Each share of Series A Preferred Stock shall be convertible, at any time, at the option of the holder, into shares of Common Stock, at an initial conversion ratio of one share of Common Stock for each share of Series A Preferred Stock. Mandatory conversion of the Series A Preferred Stock upon the effectiveness of a registration statement covering a firmly and fully underwritten public offering of Common Stock of the Company by a reputable underwriter acceptable to the Investors at a price which equals or exceeds five times the purchase price per share of the Series A Preferred Stock and where the aggregate gross proceeds received by the

Company exceeds \$25 million (a “Qualified Public Offering”).

Antidilution: The terms of the Series A Preferred Stock will contain standard “weighted average” antidilution protection with respect to the issuance by the Company of equity securities at a price per share less than the applicable conversion price then in effect, subject to standard and customary exceptions. The conversion rate of the Series A Preferred Stock into common stock will be adjusted appropriately to account for any stock splits, recapitalizations, mergers, combinations and asset sales, stock dividends, and similar events. Antidilution protection shall not be triggered by the issuance of up to 1,000,000 shares of Common Stock (or options therefor) issued in accordance with the Company’s Stock Option Plan.

Voting Rights: On all matters submitted for stockholder approval, each share of Series A Preferred Stock shall be entitled to such number of votes as is equal to the number of shares of Common Stock into which such shares are convertible. In addition, the Company shall not, without the prior consent of the holders of at least a majority of the then issued and outstanding Series A Preferred Stock, voting as a separate class:

issue or create any series or class of securities with rights superior to or on a parity with the Series A Preferred Stock or increase the rights or preferences of any series or class having rights or preferences that are junior to the Series A Preferred Stock so as to make the rights or preferences of such series or class equal or senior to the Series A Preferred Stock.

pay dividends on shares of the capital stock of the Company.

effect any exchange or reclassification of any stock affecting the Series A Preferred Stock or any recapitalization involving the Company and its subsidiaries taken as a whole.

repurchase or redeem, or agree to repurchase or redeem, any securities of the Company other than from employees of the Company upon termination of their employment pursuant to prior existing agreements approved by the Board of

Directors of the Company.

enter into any transaction with management or any member of the board of directors, except for employment contracts approved by the Board of Directors and transactions entered at arms-length terms which are no less favorable to the Company than could be obtained from unrelated third parties.

effect any amendment of the Company's Certificate of Incorporation or Bylaws which would materially adversely affect the rights of the Series A Preferred Stock.

incur or guarantee debt in excess of \$100,000.

voluntarily dissolve or liquidate.

effect any merger or consolidation of the Company with or into another corporation or other entity (except one in the holders of the capital stock of the Company immediately prior to such a merger or consolidation continue to hold at least a majority of the capital stock of the surviving entity after the merger or consolidation) or sell, lease, or otherwise dispose of all or substantially all or a significant portion of the assets of the Company.

Change the size of the Board of Directors or change any procedure of the Company relating to the designation, nomination, or election of the Board of Directors.

Amend, alter, or repeal the preferences, special rights, or other powers of the Series A Preferred Stock so as to adversely affect the Series A Preferred Stock.

Make capital expenditures of more than \$50,000 in a single expenditure or an aggregate of \$100,000 in any twelve-month period.

Liquidation

Preference: The holders of Series A Preferred Stock shall have preference upon liquidation over all holders of Common Stock and over the holders of any other class or series of stock that is junior to the Series A Preferred Stock for an amount equal to the

greater of (i) amount paid for such Series A Preferred Stock plus any declared or accrued but unpaid dividends, and (ii) the amount which such holder would have received if such holder's shares of Series A Preferred Stock were converted to Common Stock immediately prior to such liquidation. Thereafter, the holders of Common Stock will be entitled to receive the remaining assets. For purposes of this section, a merger, consolidation, sale of all or substantially all of the Company's assets, or other corporate reorganization shall constitute a liquidation, unless the holders of at least a majority of the Series A Preferred Stock vote otherwise.

Board of Directors: The Board of Directors of the Company shall be composed of five members. Of these five members, the holders of the Series A Preferred Stock shall have the right to designate two directors (one of such two directors to be designated by ABC Ventures, the other by XYZ Capital), and the founders of the Company shall have the right to designate two directors. The remaining director shall be designated by such four directors.

Options and Vesting: All stock and options held by founders, management, and employees shall vest over a four-year period. Stock currently held by founders will be considered to be 25% vested as of the closing of this financing with the balance to vest in equal monthly installments over four years. All others shall vest in equal monthly installments over four years with a one-year cliff at the beginning of the vesting term. Change of control provisions to provide for no more than an additional 50% for founders and select management and one year for all others.

Registration

Rights: Commencing on the earlier of three years from the closing or six months after the effective date of the Company's first public offering, holders of shares of Series A Preferred Stock or shares of Common Stock issued upon conversion thereof ("Registrable Stock") shall have the right to demand two "S-1" registrations with aggregate gross offering price in excess of \$10,000,000, upon customary terms and conditions.

The holders of Series A Preferred Stock will also be entitled to "piggyback" registration rights on Company registrations.

The holders of Series A Preferred Stock will also be entitled to unlimited registrations on Form S-3 with at least \$1,000,000 in aggregate gross offering price, on customary terms and conditions.

The Company will bear all expenses related to all registrations and underwritings.

Affirmative Covenants: While any Series A Preferred Stock is outstanding, the company will:

maintain adequate property and business insurance.

comply with all laws, rules, and regulations.

c) preserve, protect, and maintain its corporate existence; its rights, franchises, and privileges; and all properties necessary or useful to the proper conduct of its business.

submit all reports required under Section 1202(d)(1)(C) of the Internal Revenue Code and the regulations promulgated thereunder.

cause all key employees to execute and deliver noncompetition, nonsolicitation, nonhire, nondisclosure, and assignment of inventions agreements for a term of their employment with the Company plus one year in a form reasonably acceptable to the Board of Directors.

f) not enter into related party transactions without the consent of a majority of disinterested directors.

g) reimburse all reasonable out-of-pocket travel-related expenses of the Series A Preferred Stock directors.

Financial Statements

and Reporting: The Company will provide all information and materials, including, without limitation, all internal management documents, reports of operations, reports of adverse developments, copies of any management letters, communications with shareholders or directors, and press releases and registration statements, as well as access to all senior managers as requested by holders

of Series A Preferred Stock. In addition, the Company will provide the holders of Series A Preferred Stock with unaudited monthly and quarterly and audited yearly financial statements, as well as an annual budget.

Redemption: Commencing with the date that is five years from the date of closing and on each one-year anniversary of such date thereafter, holders of at least a majority of the then issued and outstanding shares of Series A Preferred Stock may request the Company to redeem their shares at a price equal to the original purchase price for such shares plus any declared but unpaid dividends, with 1/3 of the shares to be redeemed shall be redeemed on such redemption date, an additional 1/3 on the date that is one year from such date, and the remaining 1/3 on the date that is two years from such date.

Right of First Refusal: Holders of Series A Preferred Stock shall have a pro rata right, based on their percentage of fully diluted equity interest in the company, with an undersubscription right up to the total number of shares being offered, to participate in subsequent stock issuances.

Right of First Refusal and Cosale: In the event that any of the Founders and existing executive management propose to sell their stock to third parties, the Company shall have the first right to purchase the securities on substantially the same terms as the proposed sale; the Series A Preferred Stockholders shall next have said right according to respective percentage ownership of Series A Preferred Stock or to sell proportionate percentage pursuant to cosale rights. Such rights shall terminate upon a Qualified Public Offering.

Other Provisions: The purchase agreement shall include standard and customary representations and warranties of the Company, and the other agreements prepared to implement this financing shall contain other standard and customary provisions. Definitive agreements will be drafted by counsel to the Investors. This term sheet is intended by the parties to be nonbinding.

Expenses: The Company will reimburse the holders of Series A Preferred Stock for reasonable legal fees in connection with the transaction, payable at closing and only in the event that

the transactions contemplated by this term sheet are consummated, up to a limit of \$25,000.

Conditions to Closing: Closing shall be subject to the standard and customary conditions, including the completion of due diligence and the delivery to the investors of a legal opinion of counsel to the Company, regarding standard and customary matters and satisfactory to the Investors and their legal counsel.

By: _____

By:

The following annotations are all by Jeffrey Steele, an associate with the law firm Morse Barnes-Brown & Pendleton P.C.:

1. Equals the value the new investors are placing on the enterprise prior to their investment. Usually, all of the outstanding stock of the company, together with any outstanding options and warrants or other rights to buy stock of the company and any additional shares which may be reserved under the option pool, will be included in this premoney valuation.

2. The size of the option pool that venture capital investors will look for tends to range between 15% and 30% of the capital structure of the company. This percentage is calculated including the shares of Series A Preferred Stock being sold in the financing. The actual size of the pool can depend on a number of things, including the industry that the company is in, but is primarily related to the number and types of hires that the company will need to make in the foreseeable future. Thus, a company that has a complete management team at the time of the Series A round will likely need a smaller pool than a company that has one or more top management hires to make (each of whom may cost the company a significant amount of options or stock from the pool).

3. Often, venture capital investors also ask for an “accruing” dividend of between 8% and 10% or so per annum. This dividend “accrues” and is not payable unless (i) declared by the Board, (ii) there is a liquidation event (a sale of the company is considered a liquidation event, but an IPO usually isn't), or (iii) the preferred stock is redeemed. The accruing dividend is a protective device intended to provide a minimum rate of return but is usually forfeited in the event of an IPO or otherwise upon conversion of the preferred stock to common stock. (The theory is that in such cases the return on the investment will be more than the minimum which the accruing dividend provides. Therefore, the protection is not needed and is forfeited). There are a number of varieties of accruing dividends, including those that are payable in cash and those payable in additional shares of preferred stock. Also, although a basic “accruing dividend” involves a simple interest calculation, sometimes a so-called “cumulative” accruing dividend is requested, and it involves compound interest calculations.

4. Preferred stock should convert into common stock automatically at the company's IPO. The special rights generally accorded to preferred stock sold to early-stage investors could create problems for a public company.

5. These provisions are designed to protect an investor against “equity” dilution (later sales of stock at a

price lower than what the investor paid). Although the “weighted average” version is the most common, an alternative is “full ratchet” antidilution protection. Full-ratchet antidilution protection is far more advantageous to the investor (but punitive to the company) than weighted average, but it is usually reserved for very early-stage deals or other situations where there is significant concern as to whether the valuation will hold up over the long term. Put simply, weighted-average antidilution protection accounts more accurately for the actual dilutive effect which a particular issuance has on the investor’s equity position in the company. Full-ratchet antidilution protection, on the other hand, treats all later stock issuances below the investor’s purchase price as if they were the same, regardless of the number of shares issued.

6. Although there are venture capital investors that ask for other veto rights, this list covers some of the most frequently requested veto rights. You may not have to provide veto rights with respect to each of these matters. The key here is to try to limit veto rights to major corporate events and to try to avoid turning day-to-day operational matters into matters for a preferred stockholder vote. Thus, for example, (g) and (1) could be problematic if the dollar limits are too low. Often a compromise may be reached with respect to a request for a veto right on an operational matter by agreeing that such would be subject to the veto of the Series A Preferred Stock’s director but not at the stockholder level. That keeps the issue at the board level -- where it belongs.

7. This is a so-called “straight” liquidation preference. An alternative is the “double dip” or “participating” liquidation preference, which provides that the preferred stock get an amount equal to its money back (plus any accrued dividends if there is an accruing dividend) and then participates with common stock on an “as converted basis.” A double-dip liquidation preference is a pricing term most often seen in early-stage deals or in “down rounds.”

8. Working out what the Board will look like following the Series A round will be one of the most important matters to deal with. Generally, the Series A investors will ask for and receive representation on the board. The questions will be how many seats do they get and what effect will that have on the founders’ and management’s board representation. In the end, everybody involved will need to participate in, and be satisfied with, the decisions regarding board structure.

9. Venture capital investors will likely impose a vesting schedule on stock and options held by founders, management, and employees as a condition to investment. If shares or options are not yet vested, they are subject to being lost if the person ceases to work for the company for any reason. Venture capital investors impose such vesting requirements in order to provide the company’s people with a reason to stay with the company. Also, if a person ceases to work for the company for any reason, the nonvested shares are available for grant to his or her replacement. The theory here is, of course, that the best business plan is worth nothing without the people to execute it.

10. This list includes items frequently looked for by venture capital firms.

11. This is simply a right to achieve liquidity in the event that the company does not otherwise reach a sale or IPO by the end of the selected time period. Since the company cannot redeem stock if to do so would render the company insolvent, this right is useful only in situations in which the company has become some sort of a sideways play. Usually the redemption price is the price paid for the stock plus the accruing dividend, if there is one. Occasionally, venture capital firms will request that the redemption price be at the greater of such price and the then fair market value of the stock. The only thing to watch out for here is to make sure that the company can pay the redemption out over time. (In my experience, three payments over two years are common.)

12. While this is generally asked for and received by venture capital investors (who can give you a yes or no quickly without the need for elaborate disclosure documents to comply with the securities laws), a company should, in my opinion, think about resisting this request if it comes from individual investors.

13. The term sheet should be nonbinding (with the exception only of the exclusivity provision, if there is one, and any provisions regarding confidentiality).

14. The amount of expenses included in this provision depends on where the lawyers are from. Make sure that there is a cap. You may also want to resist any request to pay ongoing fees for the cost of complying with requests for waivers, etc., after the closing (except to the extent to which the investors incur fees

because the company breaches its obligations to them).

15. Be on the lookout for any exclusivity provisions in this clause. Usually, such exclusivity provisions require the company to refrain from taking an investment from anyone else for a set period of time after the term sheet is signed. While an exclusivity provision may be acceptable (and is often imposed), be sure to pay attention to the time period. It should be no longer than is necessary to complete the transaction, with a little extra time for possible delays. In my opinion, 30 days should be acceptable in most instances; 60 days

is pushing it in most instances; and 90 days is probably unreasonable in almost all cases. Also, make sure that the exclusivity period automatically ends in the event that the deal is called off before the period expires.

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