

*“Great Association with Quality Deal Flow”*

KEIRETSU



FORUM

## **Due Diligence Handbook**

Version 3.1

[www.keiretsuforum.com](http://www.keiretsuforum.com)

## **Authors:**

Versions one and two (released in February of 2010 and November of 2010) were authored by Walt Spevak, Kent Mitchell, and Michael Gralnick, with the support, feedback, and participation of members of The Keiretsu Forum founding region's Due Diligence Committee.

Version three (released in November of 2013) was re-written and authored by Michael Gralnick. Version three reflects an expansion of the process that incorporates substantial modifications and additions based on evolutions in The Keiretsu Forum's Due Diligence Processes since 2010. Version three also both adds new appendices that cover new procedures and modifies and expands upon several of the original appendices. Additional authors of new appendices are identified in each Appendix. Secondly, version three begins the process of adding in supplemental appendices of reference materials for consideration.

## **Handbook Copyright and Use:**

This Handbook is tailored to The Keiretsu Forum's process, in which members conduct due diligence collaboratively, negotiate and arrange deal terms as a group, and in some cases syndicate investments among members in multiple chapters and regions around both the United States and the World, yet still make individual investment decisions and invest as individuals.

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*We ask that you communicate with and share your revisions, insights, and derivative works with the authors and The Keiretsu Forum by contacting us at [duediligence@keiretsuforum.com](mailto:duediligence@keiretsuforum.com), so that The Keiretsu Forum's members may also benefit from your insights. Moreover, please share your recommendation for helpful material that might be included in additional appendices.*

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## **Handbook Design:**

This handbook is designed with three sections:

- 1- A description of the process's stages and the tasks for each stage.
- 2- Appendices containing documents that are either integral to, or supportive of, the work during the process.
- 3- Appendices of documents from other sources that might support investment decision-making by providing both related educational materials and sample documents.

Please refer to Appendix K if you are not yet familiar with The Keiretsu Forum's processes.

***This PDF document contains bookmarks for easy navigation. Please conserve paper.***

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## **Definition of An Accredited Investor**

Accredited investors are defined by the Code of Federal Regulations [Regulation D, Rule 501(a), 17 CFR 230.501(a)] to include (but not be limited to) the following: (a) "institutional investors", such as banks, insurance companies, registered investment companies, business development companies, or small business investment companies, (b) employee benefit plans within the meaning of the Employee Retirement Income Security Act if the plan has total assets in excess of \$5,000,000 or if a bank, insurance company, or registered investment advisor makes the investment decisions, (c) a charitable organization with assets exceeding \$5,000,000, (d) Directors, Executive Officers, General Partners, or certain other insiders of the issuer, (e) any natural person whose net worth, or joint net worth with the investor's spouse, exceeds \$1,000,000, excluding the value of the investor's primary residence, at the time of the purchase, (f) a natural person who has an income in excess of \$200,000 in each of the last two years or joint income with that person's spouse in excess of \$300,000 in each of those years, and has a reasonable expectation of having the same level in the current year, (g) a business in which all the equity owners are accredited investors, or (h) a trust with assets in excess of \$5,000,000, not formed to acquire the securities offered, so long as the purchase is made by a sophisticated person.

The full text of both the definition and The Securities Act of 1933 can be found by searching under Title 17 of the Electronic Code of Federal Regulations at the U.S. Government Printing Office's Website at <http://www.ecfr.gov>.

# Keiretsu Forum Due Diligence Handbook

**Goal:** The goal of The Keiretsu Forum’s Due Diligence (“DD”) process is to provide Keiretsu Forum members with the information needed to make an informed decision about investing in a company.

**Process:** The general process will be to move through six stages at the conclusion of which the company will have funds in the bank from member investors. It is to the advantage of each investor to act as part of a group when negotiating deal terms.

It is important to note that stages are not necessarily serial or consecutive. For example, deal negotiations (stage 5) may very well take place early in, and throughout, the process.

At several points along the way the process may end early. For example, if there is insufficient interest in the company or a DD Leader is not identified during the first stage of the process, then the formal Keiretsu Forum DD process will end. Similarly, if along the way member interest wanes or information is learned that is sufficient to terminate Keiretsu Forum member interest in the company, then the process will end. In both cases the DD Leader or Keiretsu Team will inform the company of this outcome and review the process to close the loop.

In the situation where the company informs Keiretsu that they have secured sufficient funds from other sources or for other reasons are no longer looking for financing, then the formal Keiretsu process will also end. In a case where the formal Keiretsu Forum DD process ends, individual members may continue to contact the company and potentially invest.

A secondary goal of The Keiretsu Forum’s DD process is to help make presenters better entrepreneurs and executives, and to leave them better off than when we first met them by virtue of their choice to present to The Keiretsu Forum. This may include providing wisdom and guidance that might improve the effectiveness of both their future fundraising and their business strategies. This should definitely include providing business introductions from within our sphere of influence.

It is anticipated that the entire process will take approximately ten weeks, beginning the week after the Forum, although it could take longer depending upon what is learned during the process.

The DD process may also diverge from the formal Keiretsu Forum DD process in a case in which there is a high level of interest, but only from a very small number of people. The process may also diverge if no DD Leader emerges. In these cases, The Keiretsu Team or someone on the interest list should inform the company that they should not expect Keiretsu Forum members to be proactive in driving the DD process forward, and that it will be the company’s responsibility to provide both initiative and information. In either of these cases, the members on the interest list should contact each other to discuss a joint-negotiation of terms.

## **Stages:**

- 1- Organization
- 2- Key Questions and Verifications
- 3- Questions Addressed/Deep Dive
- 4- Reports and Commitments
- 5- Deal Closure
- 6- Post Mortem and Syndication Decisions

# Keiretsu Forum Due Diligence Checklist

If followed closely, this defines a ten-week Due Diligence process to funding. Additional research, delays in delivery of information, or scheduling challenges can add significantly to the timeframe, often extending the entire process to three or more months.

## **Stage 1 – Organization** - first two weeks after presentation

- Initial Q&A Conference Call, Attending Member Writes Summary, Call Recorded for Others
- Communications Set Up, DD Leader Chosen, Initial Key Questions Sent to Entrepreneur
- DD Team Recruited From Interest List, DD Team Sub-Groups Assigned
- Entrepreneur Provides Baseline Information on Company and Meets With DD Leader

## **Stage 2 – Key Questions and Verifications** - third week (following Stage 1 Meeting)

- Each DD Sub-Group Forwards Additional Key Questions to Entrepreneur
- Entrepreneur Responds to Initial Key Questions, Sub-Groups Conduct Verification Checks
- DD Leader Polls Interest Level in Continuing

## **Stage 3 – Questions Addressed/Deep Dive** - fourth week (following Key Questions)

- Site Visit/Deep Dive with Entrepreneur and Company's Executive Team  
(Full Senior Executive Team Presents Detailed Strategic and Operational Plans, Q&A)
- DD Team Subgroups Complete their Industry Research and Verification Checks
- Update Posted, Conference Call Among Interested Members, DD Leader Polls Interest Level Again

## **Stage 4 – Reports and Commitments** - fifth and sixth weeks (following Deep Dive Session)

- DD Team Sub-Group Reports Prepared
- DD Leader or Report Author Completes Draft Report, Entrepreneur Comments on Draft
- DD Team Conference Call To Discuss Draft and Conclusions, Report Finalized and Posted
- DD Leader or Team Member Conducts Soft-Circle and Reports Probable Investment Amount

## **Stage 5 – Deal Closure** – seventh through ninth weeks (following final DD Report)

- Terms Negotiated, Term Sheet Written and Distributed, All Members Updated
- Final Investment Documents Completed and Distributed, Funds Delivered
- Keiretsu Team Provides Report and Access to DD Site to Other Chapter Presidents and Team

## **Stage 6 – Post Mortem and Syndication Decisions** – tenth week (following investment)

- DD Leader or Keiretsu Team and Entrepreneur Both Provide Constructive Feedback
- Keiretsu Team Asks Other Chapter Presidents if Their Members Are Likely To Be Interested
- Investing Members Contact Potential Co-Investors Outside Keiretsu and Report To Team
- Keiretsu Team Reports Potential Co-Investment Interest to Entrepreneur and Makes Introductions

# Stage 1 - Organization

First two weeks after presentation

- Initial Q&A Conference Call, Attending Member Writes Summary, Call Recorded for Others
- Communications Set Up, DD Leader Chosen, Initial Key Questions Sent to Entrepreneur
- DD Team Recruited From Interest List, DD Team Sub-Groups Assigned
- Entrepreneur Provides Baseline Information on Company and Meets With DD Leader

## Background Information - Importance of Organizing a Cohesive DD Effort

A review of statistics of investments made in Keiretsu Forum's Founding Region over a several year period up to 2012 indicates that there is not necessarily a strong causation between the level of organization in the DD process and whether or not a company receives financing. This varied based on the presenter's industry, the presenter's traction in establishing interest and typically acceptable deal terms with investors outside of The Keiretsu Forum, and the presenter's approach to dealing with potentially interested investors when no DD Leader emerged.

However, in most all cases in which the post-Forum interest list (i.e. "Gold Sheet") contained over 15 names in a region of approximately 300 members, a clear and organized DD effort with an active DD Leader preceded a sizeable investment. The only exception to this was real estate investments (in which case presenting real estate funds typically come to The Keiretsu Forum with fixed terms and significant co-investment already in place).

Leading a DD effort will take time. Effective delegation among members on both the DD Team and, if possible, the broader interest list will decrease the time required, especially if a DD Leader asks members on the DD Team to tackle specific tasks and write summaries and components of the DD Report. A DD Leader and DD Team can and should reach out to members who may not be interested in investing in a specific company to ask for specialized expertise on that company's industry and business model. The Keiretsu Forum's members operate as a community, though its members invest independently. At some point, the person you ask for help may end up interested in investing in a deal you are not interested in, and may turn to you for feedback.

If you find yourself taking a special interest in a presenting company and suspect that you might end up investing if a thorough DD process confirms that your optimism might be warranted, then it may be your turn to lead a DD process. By making sure a full DD process takes place, you will be increasing the chance that the company might end up both raising more capital and having a better chance of succeeding. Conversely, you will end up increasing the chances that fellow members might place a check on your enthusiasm.

## Pre-Forum Preparations and The Critical First Two Weeks After The Forums

The Keiretsu Forum has grown since 2000 from a traditional size angel investment group with fewer than 75 members, most of whom had come to know each other personally, to a series of chapters and regions with memberships in some regions that range from 75-300 members.

Much more now than ever before, what happens during the week before the Forums and, moreover, during the first two weeks after the Forums has tended to determine whether presenters with a significant interest list end up receiving significant capital.

As a best practice, The Keiretsu Team or leadership at each chapter to which a company presents, as well as members who are shepherding a company through the overall Keiretsu Forum process, should assure that the following steps are taken.

1. Orient entrepreneurs to what to expect during the DD process and what they must do to be successful ... either if there is an organized DD effort or if no DD Leader emerges.
2. Suggest that the entrepreneur review Appendix B of this Handbook, entitled Guidance To Be Provided To Presenters. This, however, should not be considered a substitute for tips that can only come from the members' personal experiences and knowledge of the process.
3. Establish pre-set conference call times and bridge lines for each company during the first week after the Forums, and assure that the times and numbers are in the Forum handouts and in an email after the Forums. Suggest to the entrepreneurs that they include the call times and phone numbers on the last slide of their presentation.
4. Set expectations and provide recommendations for those calls, telling the entrepreneur that the calls are designed to answer questions (not re-present) and tend to be lightly attended. The entrepreneur should be strongly encouraged to record the calls and make them available to the entire interest list.
5. Ask during the Mindshare session at the Forums who might be willing to lead DD on each company and follow up one week after the Forums with both presenters and members who marked their interest level as high to help identify a DD Leader.
6. If no DD Leader has emerged by two weeks after the Forums, communicate with the entrepreneur to assure that they know that they must back-lead the process and communicate directly with each member on the interest list independently to respond to questions, address concerns, and provide requested materials.

A member "shepherding" a company through the overall Keiretsu Forum process may either be a member that introduced a company to The Keiretsu Forum or a member that took an interest in a company either at deal screening or at a Keiretsu Forum Angel Capital Expo pre-presentation coaching session.

## **Communications Platforms - Communication Group Setup**

The Keiretsu Team will establish a communication group for communication among interested investors and uploading and sharing documents about the company.

All Keiretsu Forum Chapters typically use platforms that provide for both a place for private discussions, communications, postings, and document uploads for sharing among investors and, also, a separate section entrepreneurs can access to upload and provide all required documents. The latter is commonly referred to as a Deal Room. If a presenting company already has its own Deal Room, they should provide all interested members with access.

Members should set their preferences for daily digests or individual emails (sent whenever documents are uploaded or posts are written), according to their personal preference. If possible, The Keiretsu Team should initially set up member profiles for daily digests. This will minimize "information overload," and let members choose to switch to more frequent communications at their

own discretion. The purpose of this approach is to prevent members from having to take a proactive step to minimize potential information overload.

Currently, most Keiretsu Forum Chapters are using **Gust** (formerly known as **Angelsoft**) for both pipeline tracking and DD process communications (including Deal Rooms). Some regions are using **Central Desktop** (which also includes a project management tool) or other platforms. The Mid-Atlantic and some other regions are using platforms that they have had specially designed.

***For simplicity, in referring to “Gust,” this Handbook is henceforth referring to Communications platforms and Deal Rooms in a generic sense.***

When using the platform for uploads, postings, and communication threads, members should bear in mind that what they write and say is likely to be read and reviewed by other Keiretsu Forum members considering investing in subsequent financings, Keiretsu Forum members from other chapters considering co-investing with the initial chapter, and potentially other angel investment groups or individual angel investors outside of The Keiretsu Forum.

It is also fair to say that venture partners and their analysts, institutional investors, and strategic investors that invest either concurrently or subsequently may also review this information.

Both the DD Team and anyone on the interest list conducting the first DD process on a presenting company are creating a foundation of evaluation upon which others will eventually both evaluate and build. This makes following the guidelines expressed in Appendix A, using due care, and making reference to specific facts when making statements on communications platforms particularly important.

## **Immediate Communications**

The Keiretsu Team should send out three types of emails shortly after the Forums, and ideally at least one day before the first scheduled company conference call.

*Communications:* The Keiretsu Forum team sends a communication *to presenters* providing them with (1) the names and contact information of all members on the interest list, (2) the key data points incorporated into the Gold Sheet marked by each member on the Gold Sheet (i.e. level of investment interest, level of interest in participating in the DD process, names of members who expressed an interest in leading the DD process, and potential resources offered by members), and, finally, (3) a summary of the positive comments, negative comments, concerns, and unanswered questions discussed in the Mindshare sessions at the end of all Keiretsu Forum Chapter Meetings at which the company presented that month.

*Communications:* The Keiretsu team sends a communication *to members on the interest list* of each presenting company providing them with the direct contact information for all members who expressed an interest in possibly investing in the company. This communication should also include a summary of the consolidated notes about the company that The Keiretsu Team took during the Mindshare sessions at the Forums. By including the consolidated notes from discussions at all chapter meetings in a region, each member can benefit from the insights raised at meetings other than the meeting he or she attended that month.



*Communications:* The Keiretsu team sends a communication to *all members* in the chapter or region that provides both a reminder of the times and dial-in phone numbers for all company conference calls and a general sense of the interest level. It should include the number of members who expressed interest in investing, sub-divided by the interest level they expressed (i.e. high, medium, or low), along with the number of members who expressed a willingness to participate in the DD process and the names of any members who expressed an interest in leading the DD process. Because this is a member-wide email, the contact information of members should **NOT** be included (as it is in the email to members on each interest list).

**Key Deliverable:** The Keiretsu Team assures that all interested members have access to a company's Gust Group and that each company has access to the Deal Room component of the Gust Group. The Keiretsu Team uploads to all Gust Groups for all companies that presented a copy of the Gold Sheet with the contact information of all interested members, an independent copy of Appendix A, entitled Keiretsu Forum Due Diligence Process Values and Code of Conduct, and a full copy of this Handbook.

## Conference Calls Scheduled for Initial Questions And Answers

The Keiretsu Team will have scheduled conference calls for the week immediately following the Forums and provided in writing at the Forums and in an email to all members after the Forums the call times and dial-in numbers for each company's call. The Keiretsu Team and any member shepherding the Company through the process should strongly encourage the entrepreneur to record these calls and make them available to all interested investors by uploading the recorded audio to their Gust Deal Room.

Any member who is available should attend these calls. Participating members should summarize for the entrepreneur the positive feedback, negative feedback, concerns, and questions that members discussed during the Forum's Mindshare sessions. Entrepreneurs should address the questions and concerns. If the entrepreneur falls into re-presenting the opportunity, participants should not hesitate to interrupt in order to effectively manage time.

Participating members should attempt to ask the questions they anticipate other members will ask in addition to their own, specific questions.

**Key Deliverable:** One member on the call should volunteer to take 30 minutes to summarize the company's responses and post this summary to the Gust Group for that company.

## DD Leader Established

Any member interested in leading the DD process should contact the company. If nobody steps into the DD Leader role immediately, The Keiretsu Team and any member shepherding the company should support both the entrepreneur and interested members in both finding a DD Leader and completing Stage 1.

If at any point during Stage 1 there is insufficient investor interest in continuing, an adequate DD Team cannot be formed, or the DD effort ceases, the following communications occur.

*Communications:* If no DD Leader has emerged, then The Keiretsu Team or member shepherding the company should clearly inform the company that they should not expect

Keiretsu Forum members to be proactive in driving the DD process, and that it will be the company's responsibility to provide both initiative and information. The contact person should also advise the entrepreneur to address concerns and assess whether or not individuals might move forward toward independent investments.

*Communications:* If interest is clearly insufficient, then The Keiretsu Team should clearly inform the entrepreneur that he or she should not expect any investment from members in the chapters where the company presented. Moreover, the contact person should take the time to discuss the feedback provided by members to The Keiretsu Team or in the Mindshare sessions and provide constructive recommendations for future interactions with other investors.

**Key Deliverable:** A DD Leader is recruited from the interest list. The DD Leader should be considering investing in the company and should not be an interested party. If no member steps up to lead a formal DD process, it becomes the entrepreneur's responsibility to back-lead the DD process.

If it is clear to members interested in the company that there is significant interest but no member is willing to take the time to lead a DD process, then it will fall upon each interested member to contact other interested members to jointly negotiate favorable deal terms. Ideally, in this type of situation interested members should at least discuss with each other the information provided by the company in the Gust Deal Room.

*Communications:* Interested members should contact each other about jointly negotiating favorable deal terms.

## Initial Questions Sent to Company

The DD Leader should request and consolidate from interested investors a list of any questions or concerns to be addressed and send that list to the entrepreneur. The entrepreneur should be asked to provide a written response, which the DD Leader will post to the Gust Group. If the Company did record the initial Company conference call, then the entrepreneur should upload it to the Gust Deal Room and, also, provide and upload written responses to questions that had not been addressed on the call.

*Communications:* The DD Leader, with support from The Keiretsu Team, immediately requests and gathers for the entrepreneur initial Key Questions from both interested investors and the Mindshare session.

**Key Deliverable:** A list of questions and answers is uploaded to the Gust Group, along with the summary of the company's Q&A conference call that had been written by a member who attended the call and a recording of that call (if the entrepreneur recorded it).

**Key Deliverable:** If the investment terms have been either pre-negotiated by other investors or fixed by the company before it presented to The Keiretsu Forum, then The DD Leader assures that the Term Sheet and other investment documents are uploaded to the Gust Group.

## DD Team Recruited from Interest List and Sub-groups Assigned

The main categories of the DD process indicated below should be assigned to members of the DD Team. Individual members may hold more than one sub-group leadership position.

### Sub-groups for DD processes:

- DD Leader and, if different, DD Report Author
- Deal Negotiation and Valuation Assessment
- Verifications of Company Status and Progress, and Interviews with References
- Market, Industry, Sales, and Marketing
- Technology and Operations
- Intellectual Property Strategy
- Revenue Model and Financials

**Key Deliverable:** The DD Leader, supported by The Keiretsu Team, recruits DD Team members from the Interest List. The Keiretsu Team introduces the DD Leader to members who are not on the interest list that might be able to provide the DD Leader with feedback on the company's industry and business model.

## Communications Within DD Team About Process

Once the DD Team has formed, the DD Leader should schedule a short conference call to orient the team, prioritize action items, and establish key deliverables from each team member.

In preparation for moving forward into the remaining stages of the DD process, the DD Leader and the DD Team members should take a step back and remind each other of the importance of conducting a thorough DD process without communicating any preliminary conclusions. Specifically, the DD Team will be operating as a group that will influence a broader number of potential investors, both at the current time and in the future.

Perhaps five members are conducting the DD process to reach conclusions for only 15 members on the Gold Sheet (i.e. a sizeable amount of the interest list is involved in the DD process). Still, the conclusions and the DD Report that the DD Team produces (along with the other information the team gathers and the sub-reports and communications posted on the Gust Group) may be used as a baseline in both syndications and future financings.

Hence, unless something surfaces early in the process that completely chills interest from most all members on the interest list, it is very important that conclusions come from a thorough DD process carried out to its logical end point.

The DD Leader sets out and reminds members of the DD Team of the key standards and practices for a DD process. These communications are in large part meant as an orientation to newer members or members who have never participated in a Keiretsu Forum DD process.

*Communications:* The DD Leader mentions and discusses The Keiretsu Forum Due Diligence Process Values and Code of Conduct, as outlined in Appendix A, with DD Team members.

*Communications:* The DD Leader reminds DD Team members of the sensitive nature of communications. Specifically, DD Team members should be judicious in their communications

both inside and outside of The Keiretsu Forum with regard to the deal's status. A member's overly negative (or positive) comments early in the process could skew the course of the DD process before the process has a chance to come to completion. *Communications should be on the Gust Group so all interested investors can track and monitor the DD process. But, preliminary conclusions or generalizations should not be posted until sufficient data to draw conclusions has been gathered and put into sub-group reports or other factual summaries.*

*Communications:* The DD Leader notifies DD Team members of the need to regularly disclose relevant expertise. Specifically, in order to provide maximum value and context, members making or posting comments should include a brief note about their background and expertise and a reference to any specific source material to which other members can refer in their research.

*Communications:* The DD Leader should stress to the DD Team that all internal discussions should be kept on the Gust Group, so everyone on the interest list can stay in the loop. External communications with the Entrepreneur should also be summarized on the Gust Group for the same reason.

*Communications:* The DD Leader assures that all DD Team members disclose any interest in the company with all written communications. Specifically, DD Team members with a vested, invested, or participating interest in the company disclose their interest in the company to other DD Team members at this point. Vested interest means that the person is getting finder's fees or some other form of compensation for raising funds for the company. Invested interest means that they are a current investor. Participating interest means that they are already on a Board of Advisors or Board of Directors. DD Team members who have services that they could offer to the company disclose this here and indicate whether or not they intend to contact the company about their services and on what terms.

The DD Leader guides the DD Team in deciding the key areas to examine in the DD effort. If there are additional resources (e.g. industry experience, specialized technical skills, etc.) needed by the DD Team, this should be communicated to The Keiretsu Team to secure assistance in locating these resources.

*Communications:* The DD Leader asks The Keiretsu Team to help identify members who are not on the interest list that have additional resources and specialized knowledge that the DD Team needs to complete its investigation.

## **Entrepreneur Provides Baseline Information and DD Team Obtains Information From Other Investors**

The DD Leader should direct the entrepreneur to provide and upload to the Gust Deal Room all key information about the company as soon as possible.

At a minimum, this should include the following:

- A Report Addressing The Initial Key Questions
- The Proposed Deal (including Terms and Valuation)
- Executive Team Backgrounds
- Market and Marketing Information (including Business Plan or Business Model Canvas, Product/Service Details, and Customers)

- Operations and Technology (including Suppliers)
- The Company’s Intellectual Property Strategy
- Financials (including Financial Structure and Model, Corporate Structure, Financing History, an Ownership Overview, and The Capitalization Table)
- Pre-existing Due Diligence

Concurrently, The DD Leader should assign someone on the DD Team to communicate with pre-existing or potential co-investing investors.

*Communications - Discuss/Access Material From Prior Due Diligence:* If Keiretsu Forum members will be co-investing with a larger lead investor (such as a venture firm or strategic investor) or with members of another angel investment group, then the DD Leader or one other person on the DD Team should have a conversation about what Due Diligence the other investors have already covered, their own conclusions to date, progress in negotiating key terms, and so on. The member who has these conversations should report what they learned and their sense of the other investor on the Gust Group.

### **Meeting Between Entrepreneur and DD Leader**

The DD Leader and the entrepreneur should complete stage one of the DD process by meeting together to discuss and lay out the more detailed information and the information unique to the company that the DD Team needs to gather, understand, and verify.

At that meeting, the DD Leader should also orient the entrepreneur to the expectations for the Deep Dive session. If the entrepreneur is unfamiliar with a detailed “drill down” or “Deep Dive” meeting, the DD Leader should explain that the entrepreneur should prepare the company’s senior management team to address each executive’s detailed thoughts and plans for implementing the company’s strategy, tactics, operations, further product development, long-term path toward a liquidity event, contingency plans, and so on.

### **Chapter or Region Wide Deal Review Call**

Depending on whether or not chapter members use them, some Keiretsu Forum chapters may conduct deal review conference calls among all chapter or region members approximately two weeks after the Forums (i.e. the week after the company conference calls). These calls are intended to be both an extension of the Mindshare session at The Forums and an opportunity to update potentially interested members on the progress of all DD processes currently underway.

The DD Leader should ask one person on the DD Team (that will still be in the process of forming at this point in time) to attend this call and review for other members on the call what has emerged so far. This person should also report back to the DD Leader any new information or insights that emerged during the call, as well as the names of members on the call who want their name either added to, or removed from, the interest list. These calls should both cover the most recent presenters and provide updates on active DD processes from recent months. Ideally, one attendee should volunteer to manage the call and keep the discussion efficient, thereby limiting the call to one hour.

# Stage 2 - Key Questions and Verifications

Third week (following Stage 1 Meeting)

- Each DD Sub-Group Forwards Additional Key Questions to Entrepreneur
- Entrepreneur Responds to Initial Key Questions, Sub-Groups Conduct Verification Checks
- DD Leader Polls Interest Level in Continuing

## Role of The DD Leader in Stage 2

The DD Leader should step back during Stage 2 and let other members of the DD Team drive the effort forward. And, other members should do their best to shield the DD Leader during this stage. The DD Leader will already have put time into orienting the entrepreneur and is likely to be the most active member of the team in writing the final DD Report and leading negotiations.

It would be nice to provide presenters with a single point of contact throughout the DD process. However, if a DD Leader puts too much time in throughout an estimated ten week process (and away from his or her own personal obligations and commitments), then the process is far more likely to stall out in later stages, and ultimately take longer overall.

That said, if the DD Team is sufficiently large, a DD Leader might end up delegating more in the later stages also. For example, another DD Team member might volunteer to write the DD Report. Or, the DD Leader might ask someone with more negotiation and structuring experience to take the lead in negotiating the final deal terms.

## Additional, More Specific Questions and Answers

Ideally, all major questions will have been answered in the Q&A conference call and the initial list of questions gathered by the DD Leader from among members on the interest list during stage 1. However, more likely than not, sub-groups will develop a list of more specific questions for the company.

One member of each sub-group should interact directly with the entrepreneur to obtain responses to these questions. This can be done by submitting questions in writing and posting the entrepreneur's responses to the Gust Group. Or, this can be done in conversation, so long as the sub-group members post a summary of the questions and answers to the Gust Group.

**Key Deliverable:** One member of each sub-group should get answers to lingering or more detailed questions and post either the company's responses or the member's summary of the responses to the Gust Group.

## Beginning of Verification Process

This is the critical phase of the DD process from which "Due Diligence" gets its name. It starts in stage two (and probably week three). Yet, it continues throughout stage four and into the early part of stage five. In fact, new considerations, new information, and overlooked elements are all very

likely to emerge when Keiretsu DD Team members interact with investors outside of The Keiretsu Forum who have been conducting their own DD process.

If the DD Team is small or a DD Leader is conducting most of the effort, the verification process will take much longer than one week. ***The verification process should and must take as long as necessary.***

Verification is meant in the broad sense of the word, but should also be considered literally. The goal of each sub-group and everyone on the DD Team is to verify two different types of things:

- (1) Our understanding of (rather than our general assumptions about) the state of the relevant industry, market, and competitive landscape, and,
- (2) The accuracy and reliability of what the entrepreneur asserts about the company's history, current position, and path toward obtaining its stated objectives in that industry and market.

The latter should include “digging into” and confirming anything that might, if false or inaccurate, materially diminish the path to a liquidity event or materially increase the amount of financing required and extent of dilution.

To decide how to prioritize time, DD Team members might consider the following context. If a company is successful in achieving a liquidity event, at its most fundamental level ROI is primarily a factor of three things:

- (1) The discount applied based on the level of risk when assessing valuation at the time an investment is made,
- (2) An industry's comparable exit multiples upon a merger or acquisition or the value of public market comparables in an IPO, and,
- (3) The level of dilution that will occur in follow-on financings, especially if a company fails to meet milestones and runs low on cash.

In other words, at a macro level, and in addition to confirming the accuracy and reliability of information provided by the Company, the DD Team should investigate the following:

- (1) Has the company really achieved what the entrepreneur says it has?
- (2) What happened to analogous companies that succeeded in the same industry?
- (3) Why might the entrepreneur be overly optimistic about what it will take for the company to succeed?

The relationship between excessive optimism and dilution (i.e. point three on these two lists) refers to “dilution” in both the literal and the broader senses of the word. During the period between financings, less progress leads to a lower rate of increase in a company's valuation, which leads to a company having to issue more shares in future financings, which leads to investors having a lower than hoped for percentage of the total outstanding shares at the time of a liquidity event.

Less progress than anticipated as a company expands also leads to a company's expenses growing faster than its revenue grows, which increases a company's need for capital, which increases its vulnerability at the time of subsequent financings. This means subsequent investors have more leverage when negotiating investment terms. This usually leads to new investors imposing terms that can be harmful to the interests of earlier investors.

As it assesses the company's current foundation and future trajectory, the DD Team will be forming the best assessment possible of what the company must overcome to provide investors with a strong ROI.

Critical Risk factors vary for all investment opportunities. The various appendices to this Handbook provide various categories and lists of elements to evaluate and information to review. Ultimately, what to prioritize will emerge from the discussions among members.

***The following key deliverables reflect a bear minimum of what should be both evaluated and verified, boiled down into a top ten list. Please consider completing the evaluation and verification process in these categories of key deliverables to be necessary, but not sufficient.***

***Key Deliverable:*** The DD Team reviews all company documents referenced in the Handbook's appendices that it deems necessary to assure (1) that both all required corporate structures and all structures related to the relationship between the company and its founders and management are in place, (2) that all statements and assertions made about business relationships that have been put into place are accurate and can be confirmed, and (3) that the major accomplishments that the company claims it has achieved have actually been achieved.

***Key Deliverable:*** The DD Team (1) conducts basic background checks on founders, key executives, and major, large investors, (2) interviews references, (3) talks with previous lead and major investors to assess how the personal relationship between previous and new investors may unfold (i.e. sizes up the personality and thought processes of the people who will be representing other classes of shares), and (3) assesses the terms in key documents that will govern the relationship between previous and new investors (including the provisions in the articles of incorporation, revisions to articles of incorporation, and financing documents from previous rounds of financing). With regard to potential real estate investments, the DD Team also reviews the management contracts that govern the relationship between the fund and its management to assess the structure for management compensation and profit sharing.

***Key Deliverable:*** The DD Team communicates with investors outside of The Keiretsu Forum who are evaluating making a co-investment with Keiretsu Forum members to verify the status of their path toward co-investment and assess the information uncovered and conclusions drawn in the DD process conducted by those potential investors.

***Key Deliverable:*** With regard to potential technology, consumer products, clean technology, bio-technology, medical device, and other companies that have intellectual property involved, the DD Team (1) verifies the filing and status of those patents, (2) *verifies that all documents assigning the rights from the creators to the company are in place*, and (3) gets the assistance of both qualified intellectual property counsel and qualified technology or engineering experts to assess both the relationship between the technology and the patent claims and the sufficiency of the claims in the patents. ***Verifying that intellectual property rights were assigned from individuals to the company is critical.*** With regard to potential real estate investments, the DD Team reviews and assesses all title documents and lien filings (to the extent that is reasonably practical).



**Key Deliverable:** The DD Team confirms the elements of the path toward increased revenue and operations that the company says it has achieved, such as customer interest and stated business commitments (e.g. Letters of Intent and joint venture agreements, for example).

**Key Deliverable:** The DD Team confirms the status of product development, engineering, and product readiness.

**Key Deliverable:** The DD Team reviews in detail the assumptions underlying the financial model.

**Key Deliverable:** The DD Team reviews the features of the products of key competitors and verifies the true differentiation between the products or services of the company and the competing companies.

**Key Deliverable:** The DD Team (or an analyst or a service the DD Team uses) reviews the key statistics of the industry and market involved (e.g. market size and number of competitors, among other factors) along with both the valuation of companies in the industry and the typical exit multiples achieved by companies in the industry.

**Key Deliverable:** Both leading up to and during the Deep Dive session, the DD Team assesses factors such as (1) the management team's preparedness to capitalize on opportunities, (2) the depth of the management team's analysis of likely challenges its members might face, (3) the management team's thought process on how its members will handle key risks, obstacles, and unanticipated surprises, (4) the interpersonal dynamic between, or among, the co-founders, and (5) the corporate culture that the founders and management team has created among its employees.

***To reiterate, the key deliverables above reflect a bear minimum of what should be both evaluated and verified, boiled down into a top ten list. Please consider completing the evaluation and verification process in these categories of key deliverables to be necessary, but not sufficient.***

## **DD Leader Updates and Polls Members on The Interest List**

Within no more than several days of beginning its efforts, each sub-group should report to the DD Leader key findings from both its verification process and its interactions with the entrepreneur.

The DD Leader should then post on the Gust Group a short summary of findings from the verification process. Concurrently, the DD Leader should poll the interest list to re-assess the level of interest in investing.

If a shift is going to occur from a very large expression of interest on a Gold Sheet to an investor receiving either no funding or only nominal funding from Keiretsu Forum members, this shift is most likely to happen at the end of stage 2. The second most likely time this shift would occur is during stage 5, when deal terms are being finalized.

Members on an interest list can use Gust to update the level, and the dollar amount, of their interest in an investment. However, since the Founding Region's Due Diligence Committee has worked through the implementation of Gust into the region's procedures, it has become apparent that

whether or not members post their interest on Gust is not a reliable indicator of whether or not members will invest in a company.

Both in regard to polling and with regard to the DD process as a whole, the DD Leader should operate based on two underlying assumptions. First, the DD Leader should assume that the majority of members do not actively log into or use the Gust Platform (or other communications platforms) until such time as they are faced with a decision that requires reviewing information. Members may be glancing at emails that come through Gust to their emails for highlights. But, that does not mean that they will take the time to actively log into Gust. And, second, the DD Leader should assume that most members who expressed an interest in investing in a company will wait for the DD Report to be completed and only then review the materials that had been uploaded to or posted on Gust.

The DD Leader should conduct the polling using no less than both a Gust posting and an email to the entire interest list, along with a telephone call to members that the DD Leader feels are key influencers in the community. The process of polling an interest list is a personal, relationship centered process. The best way to complete the process may actually be based on phone calls to all members on the interest list.

*Communications:* The DD Team's sub-groups inform the DD Leader of their key findings.

*Communications:* In a Gust posting, the DD Leader updates members on the interest list on whether or not any key findings have emerged that might warrant not going forward with an investment.

**Key Deliverable:** The DD Leader polls the interest list through a Gust posting, group email, and personal phone calls to assess if interest remains sufficient to warrant moving on to the next stage.

*Communications:* If interest is insufficient, the DD process stops. The DD Leader informs both The Keiretsu Team and the entrepreneur, and moves on to stage 6, during which a DD Team member or The Keiretsu Team provide constructive feedback to the entrepreneur and receive feedback on how we as a community can do better.

## **Polling As Part of Balancing Competing Objectives**

It is important to remember that there are two, somewhat contradictory objectives in play at this point.

1. The DD process should be moving forward to its logical completion so members can make an informed decision without the preliminary concerns of a few members of the DD Team inadvertently chilling the interest of other members based on preliminary conclusions.
2. However, if something blatantly obvious emerges during the verification process that necessitates that investors not proceed **OR** if interest naturally wanes as a result of the company's responses to questions, the DD Team should not be investing its time in writing reports and the entrepreneur should not be spending his or her time away from growing his or her company and pursuing more likely sources of investment.

It is the DD Leader's responsibility to balance the equities of these objectives. Polling and regular communication informs the DD Leader's decisions.

## **Key Influencers Within The Membership**

The term “Key influencers” refers to members with deep experience in an industry. Each member must make his or her own investment decisions. But, inevitably, other members notice whether someone who has deep familiarity with an industry that expressed a preliminary interest in a presenting company continues to remain interested as the DD process proceeds.

A DD Leader should remain in contact with people with knowledge of the relevant industry throughout the DD process, but especially so during the polling process.

## **DD Leader Schedules Deep Dive On-Site Visit or Conference Call**

The DD Leader works with the entrepreneur, DD Team, and interested investors to schedule an on-site visit (or conference call, if necessary) with the company’s senior executive team to conduct a Deep Dive session. The meeting will hopefully be scheduled for a time when as many members of the DD Team as possible can attend and at a time when other members on the interest list are likely to be able to attend. The meeting is open to all members.

*Communications:* The DD Leader orients the entrepreneur to what members expect from the Deep Dive session and how the entrepreneur can maximize his or her effectiveness at the meeting.

*Key Deliverable:* A Deep Dive session, which will ideally be held as an on-site meeting, is scheduled as soon after stage 3 is completed as possible.

# Stage 3 - Questions Addressed / Deep Dive

Fourth week (following Key Question responses and verification process)

- Site Visit/Deep Dive with Entrepreneur and Company's Executive Team  
(Full Senior Executive Team Presents Detailed Strategic and Operational Plans, Q&A)
- DD Team Subgroups Complete their Industry Research and Verification Checks
- Update Posted, Conference Call Among Interested Members, DD Leader Polls Interest Level Again

## Site Visit/Deep Dive Session with Entrepreneur and Company's Executive Team

The Deep Dive session will ideally be held as a site visit. A site visit can be a valuable part of the DD process that enables members to see and assess a company's offices and manufacturing operations, if applicable. This also gives members a chance to get a sense of the company's corporate culture and get a sense of how the Company's team members and employees operate in their daily environment. Whether held in-person or by teleconference, the Deep Dive session is the opportunity for the entrepreneur's entire management team to present plans and information about their specific areas of responsibility, their plans for success, and how they plan to overcome both anticipated and unanticipated obstacles and challenges.

This is where the executive team explains "what keeps them up at night" and the DD Team gets to evaluate if the executive team has truly thought through all the things that investors believe should be keeping the executive team up at night (if they are to reduce the risk of losing investment capital and maximize the chances of producing a meaningful ROI).

If technology is involved, the CTO and senior executive team should be present and should take the attendees through a detailed explanation of how the relevant technologies were engineered. If members of the DD Team that have the essential expertise to evaluate this part of the DD process cannot attend, then this part of the evaluation should still occur at the Deep Dive session. But, a separate, technology centered Deep Dive should also be conducted with the DD Team member with essential expertise, who should then write up a summary and report for the entire DD Team.

To avoid unnecessary follow-up, a team member should advise the entrepreneur in advance that this is intended to be a Deep Dive session, not a repeat of the company's presentation. For companies located close to the Keiretsu chapter's site, as many of the company's executive team members and DD Team members as possible should attend. The more people attend, the more challenging questions will be raised, and the more precise the company's answers will have to be.

For more remote locations it is likely that only one or two team members would make a site visit, if at all. In such cases, especially for manufacturing facilities, members are encouraged to take photographs or videos for later posting to the Gust Group.

The DD Leader should encourage the entrepreneur to video this meeting. By posting the recording to the Gust Group, members who cannot attend can hear the session directly in addition to reading summaries.

Far more importantly, this will ultimately save the company time if they syndicate the deal among other Keiretsu Forum chapters or other angel investment groups, as they will not have to repeat the process.

This process is basically the same as numerous venture firms use, whereby the company initially presents to one or two partners, then participates in a Deep Dive session with analysts at the firm, who then report back to all the partners involved in making an investment decision for the applicable venture fund.

As many members of the company's senior team as possible should be involved, either in person or by phone.

Since an acquisition is a likely liquidity event in numerous angel investments (and arguably most angel investments other than real estate investments), members should assure that the company's leadership has a clear understanding of all of: (1) the path to a liquidity event, (2) the needs and decision-making processes of potential acquirers, (3) the plans for engaging in conversations with potential acquirers, and (4) the preparation the company must handle internally to prevent anything from delaying or derailing a potential acquisition when the company eventually seeks out or receives interest from potential acquirers.

To minimize the impact on the company of site visits it is suggested that only one, or perhaps two, site visits occur during the entire DD process.

*Communications:* The DD Leader provides guidance to the entrepreneur on how to maximize the company's effectiveness during the Deep Dive session.

*Communications:* If the meeting is scheduled for after the next month's Forums, the DD Leader should ask The Keiretsu Team to announce the date of the meeting at the upcoming Forums.

*Key Deliverable:* As many members of the company's senior executive team as possible, and as many interested Keiretsu Forum members as possible, complete an effective Deep Dive session. If possible, the Deep Dive session occurs at the Company's site.

## **Industry Research and Verification Checks Continue Through Completion**

The DD Leader and DD Team members who attended the Deep Dive session should update DD Team members who were not able to be present at the Deep Dive session. Ideally, this should be done by phone to convey a personal sense of the meeting. The Deep Dive session should ideally have led to a deeper understanding of the company and the industry, along with an even more specific level of questions.

All sub-groups (including those that did not have a member present at the Deep Dive session) should proceed to conduct the next level of research and verification checks. This will ultimately be the last level of information gathered and conclusions formed before the DD Team writes its DD Report for all interested members.

**Key Deliverable:** Taking into account both the new information that emerged and the deeper understanding that developed at the Deep Dive session, DD Team sub-groups resume industry research and verification checks and prepare to write their sections of the DD Report.

### **Update Posted, Conference Call, And Poll Of Interest List**

The DD Leader should post to the Gust Group a short summary with highlights of the Deep Dive session. Once again, as had been done at the end of stage 2, the DD Leader should report to the interest list via the Gust Group if anything was learned that warrants not going forward with an investment. The same balancing of equities discussed in the previous sections about polling the interest list also applies to this poll.

Ideally, the DD Leader should schedule a conference call using a bridge line to enable investors on the interest list to ask the DD Team specific questions before the DD Leader conducts the poll.

**Key Deliverable:** The DD Leader polls the interest list through a Gust posting, group email, and personal phone calls to assess if interest remains sufficient to warrant moving on to the next stage.

**Communications:** If interest is insufficient, the DD process stops. The DD Leader informs both The Keiretsu Team and the entrepreneur, and moves on to stage 6, during which a DD Team member or The Keiretsu Team provide constructive feedback to the entrepreneur and receive feedback on how we as a community can do better.

### **Delaying The DD process and Deferring A Potential Financing**

Based on what the DD Team learned at the Deep Dive session, the DD Team might recommend a temporary halt to the DD process during which the company proceeds to complete recommendations that the DD Team thinks will improve the company's chances of receiving financing from Keiretsu Forum members. This is often related to further customer development to help confirm demand for the Company's products or services.

**Communications:** If the DD Team recommends that the company complete more milestones to substantially increase the chance of receiving investment from members, then the DD Leader and the entrepreneur should discuss the recommendations and definite date for follow-up communication with the DD Leader should be scheduled. The DD Leader should update the interest list of this recommendation and timeline.

### **Update To The Membership At Large (After Deep Dive Session)**

If the DD process has proceeded according to the ideal schedule outlined in this Handbook, then the Deep Dive session may have occurred just before the next month's Forums. If so, the DD Leader should update The Keiretsu Team on the status of the DD process so they can keep members up to date. The Keiretsu Team in most chapters provides a short update on the status of active DD processes from the previous several months (during which they can request resources or expertise on behalf of DD Leaders).

# Stage 4 - Reports and Commitments

Fifth and sixth weeks (following Deep Dive Session)

- DD Team Sub-Group Reports Prepared
- DD Leader or Report Author Completes Draft Report, Entrepreneur Comments on Draft
- DD Team Conference Call To Discuss Draft and Conclusions, Report Finalized and Posted
- DD Leader or Team Member Conducts Soft-Circle and Reports Probable Investment Amount

## Preliminary Discussion of Deal Terms

Generally speaking, an investment with either deal terms or a fixed valuation that are inconsistent with the expectations of angel investors would not make it through The Keiretsu Forum's Deal Screening process. However, during the course of the DD process an entrepreneur's thought process might have shifted or investors outside of The Keiretsu Forum might have become willing to invest on terms unacceptable to Keiretsu Forum members.

Even if the general framework of the terms is acceptable, the DD Leader must at this point assess the entrepreneur's willingness to negotiate and compromise. Though the negotiation of terms occurs in stage 5, the DD Leader, or a DD Team member appointed by the DD Leader to negotiate terms, should have a preliminary discussion of what changes to the company's terms might be acceptable to the company.

If it is obvious that the terms will prevent most members from investing, then the DD Team should not invest time in writing a DD Report. In this case, the DD process will stop and the DD Leader will update the interest list and The Keiretsu Team.

*Communications:* The DD Leader or DD Team member handling negotiations reviews the acceptability of the Company's proposed deal terms and discusses potential changes to the terms with the Company.

*Communications:* If terms that the DD Leader believes will not be acceptable to the majority of members on the interest list cannot be re-negotiated, then the DD Leader informs all members on the interest list (through both a Gust posting and a group email) what the concerning terms are, that the formal DD process will end, and that members who may remain interested should proceed to conduct individual due diligence if they wish to continue forward.

*Communications:* If the formal DD process stops for this reason, then the DD Leader informs both The Keiretsu Team and the entrepreneur, and moves on to stage 6, during which a DD Team member or The Keiretsu Team provide constructive feedback to the entrepreneur and receive feedback on how we as a community can do better.

## DD Team Sub-Group Reports Prepared

If there is sufficient interest based on the polling and proposed deal terms to lead to an investment that warrants continuing the DD process, and the DD Leader has not recommended a delay in the DD process, then the DD Leader and DD Team should proceed to write the DD Report.

Each sub-group should prepare its contribution to the relevant sections of the DD Report and then provide them to the DD Leader or the DD Report's author.

These component reports cover different key areas addressed during the process (i.e. customer traction and verification, technology testing, financial model analysis, etc.). They might be very short in length. But, they must address the key risks and verify the progress and accomplishments on each subject.

**Key Deliverable:** DD Team sub-groups prepare their sections of the draft DD Report. The DD Leader contacts component report writers individually to obtain clarifications.

The DD Team should keep the company in the loop at all times during the DD process, and especially during the writing process. Sub-group members should contact the company when questions or concerns arise so the company can respond in real time and avoid delay.

## DD Report Draft Shared with Entrepreneur for Comment Then Finalized and Posted

The DD Leader or DD Team member who will be writing the DD Report compiles and incorporates the sub-group reports, any additional, not yet covered elements, and an overall analysis into a consolidated final report draft.

The author shares this with the entrepreneur, who is given a chance to address areas of concern or provide supplemental information. The DD Leader works with the company to answer any remaining questions and then completes and posts the final DD Report to the Gust Group. A final report outline that can be used as a template is included in Appendix F. A quick summary outline that can be incorporated as a part of the DD Report at the DD Leader's discretion is included in Appendix G.

If the DD Leader feels it is warranted based on the level of detail in discussions among the DD Team up to this point, he or she might schedule a conference call with the DD Team members to discuss the draft report before it is finalized.

**Communications:** The DD Leader or DD Report author seeks clarifications from sub-group members.

**Communications:** The DD Leader or DD Report author and the entrepreneur discuss the entrepreneur's concerns, comments and clarifications.

**Key Deliverable:** The Final DD Report is completed and posted to the Gust Group.

**Both the draft DD Reports and the final DD Report should include a standard disclaimer limiting liability for the DD Leader and DD Team members. One potential example is included in Appendix L.**



## DD Leader Conducts A Soft-Circle and Reports Interest Level to The Entrepreneur

At this point members hopefully have enough information about the company to indicate their interest in investing and the amount they are considering investing under the current deal terms. The DD Leader conducts a final soft-circle and reports the probable level of investment, based on the current deal terms.

If there is a very large interest list, it might be helpful to conduct an online survey (using a survey tool such as Survey Monkey) to gauge member interest under several scenarios, thereby developing a sensitivity analysis under varying valuations and deal terms. The risk of taking this extra step is that some members might get mentally locked into a certain investment amount and valuation.

**Key Deliverable:** The DD Leader (or the Entrepreneur, if the DD Leader prefers to have the Entrepreneur complete this task) completes a soft circle to assess the actual dollar amount of interest.

**Communications:** The Keiretsu Team or DD Leader provides a DD update at the next Forum that includes an overview of the path toward closing the financing.

If the deal terms are negotiable, then the process moves into stage 5 and formal negotiation begins, or continues if it has already been underway.

## Forum Status Updates - By Both Keiretsu Team and DD Leaders

As a best practice, The Keiretsu Team should be providing updates on the status of DD processes for approximately three months after each Forum. These can be done around break time or just before Mindshare, according to each chapter's preferences. The Powerpoint slides used for the DD updates should also be included in the Forum handout packet.

The announcement and slides should provide the status of the DD process, such as if DD had been terminated due to lack of interest or what stage the DD process is in, if it is ongoing. The announcement should also inform members if a DD Report has been completed or if deal terms have been worked out and a soft-circle or funding process is underway. More importantly, The Keiretsu Team should announce what resources, assistance, and specific knowledge from members familiar with a company's industry the DD Team needs. The announcement should also include a request for a DD Leader, if the company has not yet found someone to lead the process.

To supplement these announcements, The Keiretsu Team should also send out periodic updates on DD processes to members by email.

Generally, the updates will include presenters from the previous three or four months ... up until the set of Forums for which no DD processes are active.

Because not all members attend every month, these updates also serve a secondary function. Members who missed a Forum and have not yet heard of a deal in which they might be interested may learn about a company for the first time in these updates.

**Key Deliverable:** The Keiretsu Team provides updates on the status of DD processes at the Forums for several months after each Forum. They also send out periodic email updates on the status of DD processes.

When a DD process is underway on a company that received a very large expression of interest on the Gold Sheet (generally, over 25 names), a DD Leader or other DD Team member should probably opt to provide a short Due Diligence update at the Forums rather than leaving it as part of The Keiretsu Team's general DD process updates.

A full DD update covers a very brief overview of the company, the information that has been emerging in the DD process, the steps the company has been taking to address concerns, and the amount of capital that has been soft-circled (i.e. preliminarily committed). If a DD update is done at the end of stage 4 or during stage 5, then it should also provide details on the path to completing the financing, so all members get a sense of the amount that has been soft-circled, the deal terms under negotiation, and the timeline until final investment documents will be ready and funding will commence.

# Stage 5 - Deal Closure

Seventh through ninth weeks (following final DD Report)

- Terms Negotiated, Term Sheet Written and Distributed, All Members Updated
- Final Investment Documents Completed and Distributed, Funds Delivered
- Keiretsu Team Provides Report and Access to DD Site to Other Chapter Presidents and Team

## Terms Negotiated

Some deals come to Keiretsu with terms already set and the company unwilling to change them. This may be because the company already has investors under the current terms or simply believes that these terms are fair and will not negotiate. In such a case, members must decide if they wish to invest under those deal terms.

The DD Leader should already have had a preliminary conversation about terms in stage 1, and revisited that discussion at the beginning of stage 4. The DD Leader should have notified the entrepreneur of what terms Keiretsu Forum members would definitely not accept and notified members of what terms were fixed and non-negotiable. If there had been insufficient interest or inflexibility on terms that members would require or expect, then the DD process should have been halted, the entrepreneur should have been notified, and the process should have moved on to stage 6 at that point.

As the process moves from a framework that excludes “deal killer” terms to an actual structure for a long-term relationship, it is important that someone with knowledge of typical investment terms to be considered, and experience in negotiating such terms, leads this part of the process. This might be an individual or a small group. But, if the DD Leader lacks this expertise, he or she should seek another person to negotiate. This might be a willing person who is not on the interest list.

The DD Leader should also seek out members with knowledge of how to assess valuations appropriate to receiving a desirable return. This person may or may not be different than the negotiator. Ideally, this person will be familiar with the major factors that affect calculating valuation and assessing possible investor return, such as applying the more common methods of valuing early stage companies (such as discounted cash flow analysis), estimating probable dilution, evaluating typical market comparables for liquidity events in an industry, and reviewing what is workable in practice in a company’s capitalization table. Both the company’s present and possible future valuations will need to be considered.

Generally, someone involved in negotiating the valuation will have to communicate with someone familiar with the company’s industry about the company’s financial projections, and how grounded the assumptions underlying them are, in order to assess their effect on both possible investor return and an appropriate valuation.

If no one on the DD Team is comfortable negotiating the terms or familiar with these issues, the DD Leader should communicate with The Keiretsu Team to request assistance. *Ideally, the DD Leader should, at the very beginning of the process, identify the backgrounds of people on the interest list,*

*assess these needs, and, if necessary, seek someone outside the DD Team who can assist when needed.*

Typically a company will have a term sheet that serves as the basis for negotiations. If they do not have one and if Keiretsu Forum members are the primary investors investing at this stage, then a term sheet reflecting terms acceptable to interested investors within The Keiretsu Forum may have to be created and provided to the entrepreneur for discussion. Depending upon the complexity of the deal, it may be prudent to have outside legal counsel review the term sheet. Before engaging an outside firm, DD Team members must agree on how much they are willing to spend on this activity and how payment will be made.

If counsel is to be retained, it should be made clear that the counsel does not formally represent the investors, but is only providing observations. The DD Leader should discuss how payment for the services will be divided to avoid any issues among members after the fact. Because it is natural for the due diligence and negotiation processes to lead to a re-evaluation of interest, it is advisable that payment be collected and consolidated as early in the DD process as possible.

In the event that an investor outside of The Keiretsu Forum has provided the entrepreneur with a term sheet, whoever is conducting the negotiation for Keiretsu Forum members should both obtain that term sheet and discuss the progress of that investor's negotiation with both the company and the other investor.

The person negotiating with the entrepreneur should also prepare a short summary of his or her sense of the tone and tenor of the negotiation process and post this to the Gust Group. This summary may provide members with a sense of how the entrepreneur will behave both in interacting with Keiretsu Forum investors in the future and in negotiating terms with potential future investors. If the entrepreneur's approach, attitude, or beliefs may jeopardize his or her ability to solidify follow-on financing, then Keiretsu Forum members may end up at serious risk of having invested in a company that either runs out of money or ends up very low on cash on hand when negotiating with future investors.

Conversely, it may also provide an insight into how the entrepreneur might negotiate to protect the interest of existing investors from adverse terms that future investors may be seeking.

*Communications - Inquire about requests for additional terms:* Along with the draft term sheet, the person negotiating with the company should then post a request on the Gust Group that asks interested investors if there are additional terms or additional concerns that they would like him or her to address, which he or she can use in further discussions with the entrepreneur.

*Communications - Post revised terms:* After the person negotiating has reached a preliminary agreement with the entrepreneur, he or she should post on the Gust Group a list of the revised terms, along with an overview and assessment of how the entrepreneur handled the negotiating process.

Appendix P lists common deal terms (along with definitions and illustrative text). Appendix U contains a series of sample documents that are either involved with, or have an impact on, the relationship between companies and private equity investors (as provided by the National Venture

Capital Association). Appendices R, S, and T describe some (albeit by no means all) valuation methodologies.

### **Keiretsu Member Board Seat Negotiated and Board Member Selected**

If the total amount of soft-circled funds is sufficient, the person negotiating should attempt to secure a Board Seat for Keiretsu Forum members (if one is not already in place). If this is not possible due to the overall Board composition and number of other investors, Board observation rights should be requested. If it seems like a Board Seat can be secured, the DD Leader should inform all members on the interest list of this possibility and actively seek a candidate. Identifying and presenting the company with a candidate that can help them grow *before* requesting Board representation should help secure that representation.

If the company agrees to provide a Board seat but none of The Keiretsu Forum members who go forward with an investment have either the requisite domain experience or general expertise relevant to the company's specific stage of growth, then the DD Leader and the company might ask a well suited Keiretsu Forum member who is not making a financial investment in the company to join the Board. They should both ask The Keiretsu Team to help them identify such a member and, also, make requests at the Forums. A member who might be a very good Board candidate might be a member of a different chapter or region. The DD Leader should ask The Keiretsu Team to communicate the request to the leadership and Keiretsu Team members in other chapters.

Historically, the process of selecting a Board Member to represent Keiretsu Forum members who invest in a company was an informal process that involved a relationship between the company and a group of members who either knew each other or, at least, knew of each other.

More recently, as deals have been syndicated among multiple chapters, the process of selecting and maintaining a long-term Board Member to represent the interests of Keiretsu Forum members in a Keiretsu Forum portfolio company has come to require introducing new structures and recommended procedures.

There is now a multi-dimensional set of dynamics involved between the portfolio company, the members of the first chapters to invest, the members of chapters that invest subsequently in the same financing, and the members that might invest in subsequent financings. Members who co-invest in the same financing are far less likely to know each other than they had been in the past. And, we can reasonably anticipate that subsequent investments might include people who invest larger dollars amounts or involve people with more relevant domain expertise or industry experience.

Our shared objective is to protect our mutual interests by both maximizing the additional value we can provide and minimizing any potential disruptions to management's time and focus over the long-term. Providing clarity on who will serve as a representative of the members who invest over time will be helpful to our portfolio companies.

To that end, Appendix M lays out procedures to be used among Keiretsu Forum members to select and maintain a Board member over time.

## Final Term Sheet Distributed and Hard Circled Financial Commitments

When negotiations are completed, either the entrepreneur's legal counsel or the attorney advising Keiretsu Forum investors (if one is being used) should finalize the term sheet. The Keiretsu member who has been negotiating with the entrepreneur should post the final term sheet on the Gust Group and notify members on the interest list that it has been posted.

The entrepreneur's legal counsel should provide any stock purchase agreements and final investment documents that will be based on the final term sheet, along with documents that prior investors will use to approve the terms of this investment, revisions to articles of incorporation and/or bylaws that will be completed as part of the investment transaction, and any related documents. The person conducting the negotiations should both place these documents on the Gust Group and post a note for members on the interest list highlighting any terms of concern that stand out.

If possible, these documents should be made available to investors before investment decisions are made. *This will assure that there are no surprises that show up as documents that are more detailed than the term sheet are finalized for signatures.*

The company will then provide instructions to members as to how to deposit their funds. Members will decide if and how much they wish to invest in the company under the negotiated terms, and transfer their funds at this point.

It is expected that all Keiretsu Forum members participating in the same financing round invest with the same negotiated terms and conditions after the DD process and negotiation has been completed.

The only exception to this might be if the company is providing an incentive such as a discount or warrants for participating in an earlier closing date.

***In the event of a bridge financing or staged closing, the DD Leader should do his or her best to facilitate coordination among all members on the interest list. If the DD Team anticipates negotiating adjusted terms, then the DD Leader or negotiator should accelerate negotiations to an earlier stage of the DD process.***

Even if the terms of the earlier closing date are structured as part of a convertible note or other instrument that converts into the equity terms that the DD Team ultimately negotiates, when more money is invested early on, the leverage will change and it will become harder for the DD Team to negotiate changes in the company's proposed terms, thereby potentially harming the interests of other Keiretsu Forum members.

***Key Deliverable:*** A final term sheet is negotiated, final investor documents are completed, and the financing is completed.

## Keiretsu Team Provides DD Report, Update, and Gust Group Access to Other Chapters

The Keiretsu Team should, ideally, have already been in contact with other Keiretsu Forum chapters about presenting companies that received very significant interest on the Gold Sheet. They should also have notified the Chapter Presidents or Entrepreneur Directors of other chapters when the final DD Report was posted.

For all investments that went through a thorough DD process, The Keiretsu Team should also notify the Chapter Presidents or Entrepreneur Directors of other chapters late in stage 5 when a financing is entering the closing process.

The Keiretsu Team should provide them with access to the Gust Group so they can review the DD Report, along with all the documents that had been uploaded and posts that had been written during the DD process.

For all chapters using the Gust Platform, Chapter Presidents and Entrepreneur Directors will already have access to pipeline tracking and all Gust Groups within all chapters. All that will be necessary is an email communication that provides the company's one paragraph overview and a summary of the level of financing involved.

Even when chapters are using different communications platforms, every Chapter President and Entrepreneur Director should have access to the platform used for every other chapter that is sufficient to allow them to review each company's Communications Group and Deal Room. If this has not been established between two chapters, The Keiretsu Team should at least provide the leadership of the other chapters with the final DD Report and term sheet along with the company's one paragraph overview and a summary of the level of financing involved.

Additionally, as a best practice, Chapter Presidents should be discussing highlights of presenting companies during their Chapter President conference calls.

# Stage 6 - Post Mortem and Syndication Decisions

Tenth week (following investment)

- DD Leader or Keiretsu Team and Entrepreneur Both Provide Constructive Feedback
- Keiretsu Team Asks Other Chapter Presidents if Their Members Are Likely To Be Interested
- Investing Members Contact Potential Co-Investors Outside Keiretsu and Report To Team
- Keiretsu Team Reports Potential Co-Investment Interest to Entrepreneur and Makes Introduction

## Final Review Process with Company

The DD process may conclude before reaching Stage 6 with no member investment made. Hopefully, the full process will have occurred including funding commitments having been made and funds having been deposited. Either way, the process probably involved a significant investment of time by both entrepreneurs and members. Our collective objective as Keiretsu Forum members should be for every company that presented to be left with a good feeling about their experience with both The Keiretsu Forum and its members ... even if they did not receive any investment.

This is why this Due Diligence Handbook has referenced in each stage jumping to the Post Mortem communications of stage 6 whenever and wherever in the process a DD process is halted.

## Meeting or Conference Call - Post-Deal Review with DD Team and Company

A final meeting to review the process will be held, preferably in person, between the company, the DD Leader, and any other DD Team members who wish to attend. This should include a discussion of what went well and what could have been done better by both sides of the interaction, member recommendations for how the company can be more effective in its capital raising processes in the future, and how The Keiretsu Forum can further improve its DD process.

If the DD Leader has received feedback that might lead to a significant improvement in The Keiretsu Forum's DD processes, the DD Leader should relay that feedback to both his or her Chapter President and, also, to the Founding Region's Due Diligence Committee at [duediligence@keiretsuforum.com](mailto:duediligence@keiretsuforum.com). Suggestions sent to that email may be incorporated into future versions of this Handbook and discussed among chapter Presidents and Keiretsu Team Members.

The outcomes of this meeting should be:

1. The entrepreneur feels a sense of completion, and hopefully has a positive sense of his or her experience with The Keiretsu Forum and its members, regardless of whether or not Keiretsu Forum members invested.
2. The DD Leader summarizes the reasons related to the company that members had for making their investment decisions.
3. Members give feedback to the entrepreneur about the company's strengths and weaknesses, as perceived by the DD Team's members, along with how the company can improve its fundraising processes and become more prepared for DD processes in the future.
4. The company comments and provides feedback on the DD process.
5. The Keiretsu Team and Due Diligence Committee members learn and assess methods of further improving The Keiretsu Forum's DD process and Due Diligence Handbook.



**Key Deliverable:** The Post Mortem meeting or conference call between the DD Leader and the entrepreneur takes place, providing both sides of the interaction with constructive feedback.

**Communications:** The DD Leader relays any feedback that might lead to a significant, long-term improvement to The Keiretsu Forum's DD process to both the Founding Region's Due Diligence Committee at [duediligence@keiretsuforum.com](mailto:duediligence@keiretsuforum.com) and his or her Chapter President.

## Setting An Expectation About Long-Term Communication with Keiretsu Forum Members

One of the DD Leader's final responsibilities between the close of the financing and the Post Mortem wrap-up in stage 6 is to assure that expectations are set for the future relationship between the company and Keiretsu Forum members.

Historically, one major area where problems have arisen with Keiretsu Forum portfolio companies over the years is communication after the investment. Many entrepreneurs neglect to keep their investors updated.

This can quickly become a source of tension. Moreover, a lack of communication translates into a lack of both valuable assistance and invaluable preventive medicine.

The Keiretsu Forum's members have a very significant knowledge base, level of expertise, and contact grid. And, members routinely ask each other for contacts to help the companies in which they have invested move forward (or should do so, if they do not). If a company is having challenges and needs help, the members can only help if they know of the problems before they escalate.

The worst manifestation of the lack of communication can be extremely destructive to an investor's ROI. Arguably, one of the worst practices busy entrepreneurs fall into is to start financing cycles too close to when the company needs money. And, though one function of venture funds and organized angel groups is to help entrepreneurs raise follow-on financing, entrepreneurs often let these key relationships with investors dissipate and then suddenly show up out of the blue needing money. If a company is low on cash on hand when negotiating a follow-on financing, the terms of the subsequent financing will inevitably involve both increased levels of dilution and terms that are preferential to subsequent investors (and, hence, harmful to the interest of existing investors).

Updates do not need to take much time. The practice can be as simple as sending investors a several paragraph long email every month and providing updated financials every quarter (which the company should be maintaining anyway).

The DD Leader should assure that, after the DD process ends, one member who invests in the company is designated as the point of contact for ongoing communications between the company and Keiretsu Forum investors. This individual can relay member questions and concerns to the company. He or she can also report back to the broader Keiretsu Forum membership over time on the status of the investment.

**Communications - Request regular updates from Entrepreneur.** The DD Leader should recommend that the entrepreneur take a short amount of time every month and provide a brief email update to the company's investors, in addition to providing more detailed quarterly updates that include updated financials. The DD Leader should point out that

Keiretsu Forum members have historically had more positive working relationships with portfolio companies that take this extra step and communicate with us more regularly, and that Keiretsu Forum members have an enormous contact grid and level of expertise that can benefit its portfolio companies, if the company keeps its investors updated on what it needs and how its development is progressing.

**Key Deliverable:** The DD Leader sets expectations for long-term, ongoing contact between the company and its investors. If Keiretsu Forum Members do not have a Board Seat, the member who will serve as a point of contact to check in with the company periodically is selected and identified.

**Key Deliverable:** The DD Leader assures that the selected contact person has the names and direct contact information for all Keiretsu Forum members who invested in the company. Moreover, the DD Leader assures that the list of new investors and investors from previous financings and other chapters are integrated into an updated list that is given to the contact person.

If an investment has been made, these may arguably be the most important key deliverables of both stage 6 and the entire DD process.

***It is essential that, upon completion of the process, the DD Leader create a list of all members who invested, along with their contact information, and posts this list to the Gust Group.***

*This will enable members to communicate with each other if there is ever a problem with the company that requires Keiretsu Forum investors to coordinate and act as a block of investors.*

**Key Deliverable:** The DD Leader creates a list of the names and contact information of all members who invested and posts this list to the Gust group, thereby enabling investors to communicate with each other. As other chapters join, the DD Leader for that chapter should update the list.

## **Communications Regarding Syndication**

The leadership of other chapters should by now have had a chance to assess if, based on their knowledge of their membership, their members might be interested in investing in a presenting company from another chapter or region. In making their assessment, they should definitely factor in both the types of investments and industries that their members typically favor and whether or not their members are interested in investing in a company that is not local.

Based on soft circles in one chapter or region, a presenting company may already have presented concurrently in multiple regions at the early part of stage 5. Either way, at the close of stage 6 The Keiretsu Team should follow-up with other Chapter Presidents to get their feedback and relay that information to the entrepreneur.

Concurrently, Keiretsu Forum members who invested should be reaching out among their contacts to other individual investors, angel investment groups, and funds that invest in the company's industry and at the company's current stage of development.

The feedback received regarding potential co-investment from other Chapter Presidents and potential co-investors outside of Keiretsu, along with the relevant contact information, should be

relayed to the entrepreneur through The Keiretsu Team and the member who has begun serving as the contact person between the Keiretsu Forum investors and the company.

*Communication:* The Keiretsu Team confers with other chapter Presidents, and Keiretsu Forum members who invested confer with potential co-investors who are not Keiretsu Forum members, about possible interest in deal syndication.

**Key Deliverable:** The entrepreneur receives a qualitative briefing of the potential interest in deal syndication so he or she can make an informed decision about whether or not to invest time and resources into pursuing a broader syndication initiative through The Keiretsu Forum.

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**Due Diligence Handbook**

**Appendices**

# Due Diligence Handbook Appendices

## DUE DILIGENCE PROCEDURES

<b>APPENDIX A – KEIRETSU FORUM DUE DILIGENCE PROCESS VALUES</b>	<b>1</b>
<b>APPENDIX B – GUIDANCE TO BE PROVIDED TO PRESENTERS</b>	<b>3</b>
<b>APPENDIX C – DOCUMENT REQUEST SEQUENCE</b>	<b>6</b>
<b>APPENDIX D – SAMPLE QUESTIONS FOR REFERENCE CHECKS</b>	<b>9</b>
<b>APPENDIX E – DEEP DIVE AND SITE VISIT PROCEDURES</b>	<b>10</b>
<b>APPENDIX F – FINAL DD REPORT OUTLINE</b>	<b>12</b>
<b>APPENDIX G – QUICK SUMMARY FOR WITHIN FINAL REPORT</b>	<b>18</b>

## COMPANY INFORMATION

<b>APPENDIX H – COMPANY OVERVIEW</b>	<b>20</b>
<b>APPENDIX I – DOCUMENT BINDER</b>	<b>22</b>
<b>APPENDIX J – INDUSTRY-SPECIFIC QUESTIONS</b>	<b>28</b>
<b>SOFTWARE</b>	<b>28</b>
<b>HARDWARE</b>	<b>29</b>
<b>LIFE SCIENCES - BIOTECHNOLOGY</b>	<b>30</b>
<b>TELECOMMUNICATIONS -WIRELESS</b>	<b>31</b>
<b>REAL ESTATE</b>	<b>32</b>

## **SUPPORTING INFORMATION**

<b>APPENDIX K – KEIRETSU FORUM APPLICATION AND INVESTMENT PROCESSES</b>	<b>34</b>
<b>APPENDIX L – STANDARD DISCLAIMER FOR DUE DILIGENCE TEAM MEMBERS</b>	<b>39</b>
<b>APPENDIX M – ADDITIONAL FACTORS TO CONSIDER WHEN EVALUATING COMPANIES IN SPECIFIC INDUSTRIES</b>	<b>40</b>
<b>APPENDIX N – PROCEDURES FOR SELECTING AND MAINTAINING A KEIRETSU MEMBER BOARD SEAT</b>	<b>43</b>
<b>APPENDIX O – GUST OVERVIEWS</b>	<b>49</b>
<b>GUST OVERVIEW PROVIDED BY GUST</b>	<b>50</b>
<b>GUST OVERVIEW FOR MEMBERS PROVIDED BY THE KEIRETSU FORUM</b>	<b>66</b>
<b>APPENDIX P – COMMON DEAL TERMS, DEFINITIONS, AND ILLUSTRATIVE TEXT</b>	<b>74</b>
<b>APPENDIX Q – CREATIVE DEAL TERMS</b>	<b>88</b>
<b>APPENDIX R – VALUATION METHODOLOGIES: AN IMPERFECT WORLD</b>	<b>90</b>
<b>APPENDIX S – VALUATION TECHNIQUES: A BETTER TECHNIQUE FOR DISCIPLINED VENTURE INVESTMENTS</b>	<b>95</b>
<b>APPENDIX T – VALUATION AND FOUNDERS’ STOCK: COMPANY VALUE DRIVES THE VALUE OF FOUNDER’S STOCK</b>	<b>102</b>

## ITEMS FOR CONSIDERATION

<b>APPENDIX U – NATIONAL VENTURE CAPITAL ASSOCIATION SAMPLE DOCUMENTS (AS OF LAST RELEASE IN 2011)</b>	<b>118</b>
<b>TERM SHEET</b>	<b>121</b>
<b>STOCK PURCHASE AGREEMENT</b>	<b>137</b>
<b>CERTIFICATE OF INCORPORATION</b>	<b>190</b>
<b>INVESTOR RIGHTS AGREEMENT</b>	<b>236</b>
<b>VOTING AGREEMENT</b>	<b>280</b>
<b>RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT</b>	<b>311</b>
<b>MANAGEMENT RIGHTS LETTER</b>	<b>337</b>
<b>INDEMNIFICATION AGREEMENT</b>	<b>339</b>
<b>MODEL LEGAL AGREEMENT</b>	<b>367</b>

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KEIRETSU



FORUM

**Due Diligence Handbook Appendices**

**Due Diligence Procedures**



# APPENDIX A - Keiretsu Forum Due Diligence Process Values

The due diligence process is the mechanism through which Keiretsu Forum members discover whether an investment is worthwhile. It is also the point where “bad behavior” can result in sub-optimal decisions, negative feelings among members, and even a bad reputation for both The Keiretsu Forum and its members in the investment community. As such, observation of a code of conduct that conforms to peer expectations is important.

1. **Open Process.** The DD process should be conducted in an open, democratic, professional, and collegiate manner. Members who express an interest in being involved in due diligence should not be excluded. Access to management, documents and information obtained as part of due diligence should be shared openly, subject to requests of confidentiality (e.g. management references or customer lists). All members who express interest in investing should be given fair access to the investment opportunity. Open debates are fair game, subject to the considerations below to due process, and no views expressed after due deliberation should be arbitrarily or unilaterally excluded from publication.
2. **Due Care with Public Forum.** Discussions in an open forum - whether online, in conference calls, or in meetings - should take into consideration that careless remarks, whether positive or negative, affect other people’s pocketbooks, and sometimes result in shutting off a company’s lifeblood. Stated opinions, whether positive or negative, should be duly considered; factually correct; and based on facts, impressions honestly derived from the process, and expertise developed elsewhere (such as from experts who were consulted).
3. **Healthy, Respectful Assessment.** The DD Team and interested investors will pose tough questions and raise challenges to the business model. The spirit of the debate is to try to identify the potential challenges, assess the likelihood that they will emerge, weigh their potential impact, and understand the potential mitigations in place. This is done knowing angel investing involves risk and even the most attractive companies have their weak spots. The discussion about these potential challenges will take place in a balanced way -- avoiding premature conclusions, personal charges, doom and gloom, and over-reaction.
4. **Due Process for Negative Views.** It is important for members to share their views, whether positive or negative, in order for all to benefit from due consideration. However, since negative views often have the effect of shutting down a company’s access to capital, care should be exercised in their expression. Specifically, when expressing a negative view, be sure to have checked all the facts, allowed the company a chance for rebuttal, and discussed among the DD Team (not the entire Interest List) the views you intend to express. When arbitration is required, involve the DD Leader, or even Keiretsu Team members (the Keiretsu Chapter’s Entrepreneur Director is the appropriate person.) This does NOT mean that negative opinions should be suppressed; merely that they are expressed after due consideration.

5. **Full Disclosure of Relationships.** Everyone participating in due diligence will openly disclose to interested investors, the DD Team, and the company any relationships they have that might create a perception of a vested interest (i.e. not just an actual vested interest). That would include prior investments in the company, services performed or under discussion with the company, involvement of any kind with a competitor, or past relationships with any members of the management team.
6. **Contributing Members of The Team.** Active participants in DD process will have authentic potential interest in investing, or possess domain expertise that may be valuable to those considering an investment. DD Leaders or team members may invite experts to participate in the DD process as appropriate. Persons should not participate in due diligence for the sole purpose of marketing their services to the Entrepreneur.
7. **Opportunities for Review.** The DD Team will share findings, draft reports, points of view, and final documents with the company's management team in advance of sharing with the rest of the interested investors. This will provide the management team an opportunity to correct factual errors, point out tone issues, and prepare a response if necessary. We believe in the value of "no surprises" for anyone involved in the process.
8. **Participating for Education.** It should be noted that there is one minor exception to this code of conduct, which relates specifically and only to the expectation that the contributing members of a DD Team (other than those providing domain expertise) have an authentic potential interest in investing in the presenting company. The Keiretsu Forum recommends both that new angel investors not make an investment during the first six months after joining and, also, that every new member participate in a DD process shortly after joining the membership. Each new member should participate in a DD process, thereby learning about the process by "shadowing" a DD Leader. A member participating in this manner should disclose this type of participation to both the entrepreneur and the DD Team.
9. **Respect for Entrepreneur's Time and Cash.** We understand the challenges of launching a business, and that raising angel financing is just one of many priorities for the entrepreneur and management team. We also understand the expenses sometimes involved in courting investors, at a time at which cash is tight. We endeavor to scale the due diligence and fund raising activities to yield a good return on the entrepreneur's investment.

# APPENDIX B - Guidance To Be Provided to Presenters

This Appendix is designed to provide an outline of information and tips to discuss with presenting entrepreneurs about how to maximize their potential for success during the due diligence process. The Keiretsu Team and a Keiretsu Forum member who is shepherding a company through the process, if any, should take some time to discuss the content below with entrepreneurs. Presenters should also be given a copy of this Handbook.

Please email insights and suggestions for other information that should be discussed and tips that might be included in future versions of this Appendix to [duediligence@keiretsuforum.com](mailto:duediligence@keiretsuforum.com).

1. An estimate of the timeline for a typical Keiretsu Forum DD process.
2. Possible legal expenses that the company will have to incur as part of preparing investor documents and closing a financing.
3. What to expect during the DD process and what they must do to be successful if there is an organized DD effort.
4. What to expect during the DD process and what they must do to be successful if there is no organized DD effort or DD leader.
5. The value and importance of proactively calling members on the interest list promptly, rather than waiting for a DD Leader to emerge.
6. Both the access information for the Bridge Line setup by The Keiretsu Team for their Q&A conference call and the company that provides that Bridge Line (so the entrepreneur can take steps to use that company's recording feature).
7. The importance of recording both the initial Q&A conference calls and the Deep Dive session for the benefit of both members with busy schedules and members of other chapters or angel investment groups that join the DD process later in a multi-chapter or syndicated financing.
8. The recommended structure for the Q&A call, as follows:
  - a. Ask members to introduce themselves quickly, so the presenter can get a sense of the backgrounds and expertise of the members on the call.
  - b. A several ... but no more than five ... minute reminder overview of the company.  
***Remember, participants should feel free to stop the entrepreneur if he or she falls into re-presenting a full presentation, which is not the function of the call.***
  - c. Address concerns and questions that came up in the Forum's Mindshare session(s), as summarized for the entrepreneur in the initial, post-Forum email from The Keiretsu Team.

- d. Open the floor to questions and discussion.
  - e. Ask for referrals to a potential DD Leader (if nobody interested in leading the DD process attended the call).
9. The lack of a correlation between how many people attend the initial Q&A conference call and the ultimate amount invested.
  10. The usefulness of calling and at least leaving voicemails for members on the interest list confirming their participation on the Q&A call, thereby reminding them of the time, and proactively asking them to email the entrepreneur any questions they would like addressed.
  11. The importance of trying to seek out a member on the interest list that might be willing to serve as a DD Leader.
  12. The importance of maintaining communication with The Keiretsu Team to keep them updated on any concerns they have about the progress of the DD process or interactions with members during the DD process.
  13. Which chapters are most likely to have a membership base that will be attracted to their specific investment opportunity, if they also choose to seek investment from other chapters.
  14. How The Keiretsu Forum and its members use Gust and how the entrepreneur should use Gust.
  15. What kinds of materials they should begin to gather, compile, and post in their Gust Deal Room for both the DD Team and all members on the interest list (as outlined in other appendices to this Handbook).
  16. The usefulness of placing the dial-in phone number and password for the Q&A conference call on the closing slide of their presentation.
  17. The role, potential value, and schedule for Keiretsu Forum Entrepreneur Academies.
  18. The following, general suggestions:
    - a. Try to identify thought leaders within the relevant industries within The Keiretsu Forum's membership, ideally starting during their preliminary interactions with members if they attend Keiretsu Forum meetings before they formally present.
    - b. Devote time during the DD process to members who have a strong interest in conducting due diligence or seem to have expressed a higher level of interest in investing (based either on what box they checked on the interest list or on discussions early in the DD process). In this context, the entrepreneur should bear in mind that most members will not make decisions until several other people complete the DD process for them.
    - c. Remember that time is of the essence. The Keiretsu Forum operates on a monthly

cycle. Members know that there is an opportunity cost in their choice of how they deploy money that they intend to put to private equity investments. And, they know that they will be introduced to several new opportunities each month.

- d. Move quickly to make their materials available to members in the Gust Deal Room.
  - e. Respond to communications from members with questions about the company as quickly as possible.
  - f. The DD process, like the presentation, is about continuing to show the strength of the opportunity.
  - g. Stay in active contact with members of The Keiretsu Team to keep them apprised of how the DD process is progressing.
  - h. Do not take a lack of interest, or a decrease in interest, personally. Keiretsu Forum members see approximately 60 private equity investment opportunities per year from within The Keiretsu Forum alone, more if they attend deal screenings, and even more from within their personal networks outside of The Keiretsu Forum. Interacting with angel investors that operate in groups is a matching game, in which entrepreneurs and investors are seeking the best fit. One of the key benefits of presenting to The Keiretsu Forum is that there is a strong diversity of interests within the membership. The return on their investment of both time and resources from presenting to The Keiretsu Forum comes from finding the right matches, not necessarily from trying to create interest in investing by spending time pursuing as many members as possible.
19. Specifically encourage entrepreneurs to use blind copies (i.e. bcc) rather than the to or cc fields when sending emails to members on the interest list. This will prevent members from inadvertently pressing reply all ... thereby increasing the level that members are inundated with email communications about the company. Long back and forth chains of emails about the company can inadvertently lead to members not noticing information that is either relevant to what they need to know or very important.

# Appendix C - Document Request Sequence

Appendix I (referring to the Document Binder) covers a list of many of the documents that should be reviewed in an exhaustive DD process. However, all companies that present to The Keiretsu Forum are at different stages of development. The DD Team may not want to review every document on that list.

The DD Leader should ask someone from the DD Team to address both the full scope and the targeted scope of documents that the DD Team will want to review. First, that member should direct the entrepreneur to both this Appendix and Appendix I regarding the due diligence binder, both of which outline what documents a DD Team should review at different stages of an exhaustive DD process. Second, that person should provide guidance to the entrepreneur on which documents the DD Team will likely want to review, given the company's specific stage of development. And, third, that person should outline types and categories of documents, thereby reminding the entrepreneur to consider what else, in addition to what is being requested, will also help him or her make his case for receiving an investment.

Invariably, the DD Team's members will want to see more material and documents as the DD process progresses and their understanding of the company evolves. To keep the pace moving and respect the entrepreneur's schedule, the DD Team should do its best to anticipate what additional or supplemental documents it might want to review and make those requests as soon as possible.

This Appendix serves as a high-level summary and general outline for the sequence of requesting documents. Generally speaking, documents should be requested and provided in groups as the DD process progresses. This will save the entrepreneur time by preventing him or her from taking the time to gather and upload documents if the DD process is not going to progress further.

***Please be alert for references in this Appendix that highlight or emphasize what to look for in some of the specified documents.***

*The stage numbers below reference the documents that should be uploaded just before that stage begins. This assumes that the DD Leader has indicated ... just as the prior stage is ending ... that investor interest remains sufficient to continue the DD process.*

## Just before Stage 1: Organization

The company should upload ... whether or not the DD Team specifically requests it ... documents related to understanding the company's historical progress, launch plans, and growth plans, along with all other documents the management team feels will help bridge the gap between what was covered in the initial presentation and what will be covered in the Deep Dive session. The entrepreneur should consider the questions that came up in the Mindshare session, as relayed by The Keiretsu Team.

Among other things, this should include the filled in Keiretsu Forum overview, general executive summary, Powerpoint investor presentation and handouts, business plan or business model canvas, financial model, assumptions underlying the financial model, technological overview, marketing plan, competitive analysis and comparison to competitors' products or services, market and industry explanations or whitepapers, writings by the management team explaining the industry that might help investors better understand both the team and the industry, market analysis, sales pipeline, and so on.

Proposed deal terms and draft financing documents should also be uploaded, because the DD Leader will be assessing, as a prerequisite for continuing the DD process, whether or not the proposed terms will be generally acceptable to members on the interest list.

### Just before Stage 2: Key Questions and Verifications

The company should provide the names of all personal references and customer references. The company should upload all documents that confirm what its leadership has said it has achieved with regard to customer acquisition, strategic partnerships, and so on. The company should also upload its capitalization table and shareholder list and provide the DD Team with the contact information of the lead investors from previous financings.

The company should also upload and the DD Team review all the documents specified in Appendix I's sections on corporate documents and on litigation and regulatory compliance. For real estate investments, the company should upload and the DD Team review all the documents specified in Appendix I's section subtitled property.

And, the company should upload for review all financial statements and all the documents that the DD Team said it will want to review from Appendix I's sections on intellectual property and employee relations.

***When patents are involved, it is critical to assure that all documents required to assign rights from the people who created the claimed technology or features to the company have been signed and are in place.*** Therefore, all signed assignment of inventions agreements should be uploaded as soon as possible. The DD Team should specifically cross-reference and look for assignment provisions in the employment agreements to make sure there is no inconsistency in the employment agreements (or agreements among the co-founders) that might override or undermine the provisions within the assignment of inventions agreements.

### Just before Stage 3: Questions Addressed/Deep Dive

The company should upload whatever documents the entrepreneur feels that the DD Team should review before the Deep Dive session in order for investors to be prepared for that session. In the case of companies involving technology, this should include enough of an overview for people without an engineering background to be ready to track the conversation at the Deep Dive session (though the company may prefer to only provide detailed technology architecture explanations directly to the person on the DD Team handling that part of the DD process).

Additionally, the company should upload for review any documents that the DD Team tells the entrepreneur it wants to review in preparation for the Deep Dive session.

#### Just before Stage 4: Reports and Commitments

The company should upload for review at this point the documents that the DD Team said it will want to review from Appendix I's sections on contracts and commitments, finances, taxes, insurance, and government licenses, permits, and filings.

It might seem like these documents should also have been provided just before stage two, before the verification process commenced. Yet, by deferring this deeper review until just before stage 4, two things can be accomplished.

First, the essential information is less likely to be missed or overlooked. And, second, if something fundamental or critical stops the DD process from progressing, the entrepreneur will not have had to spend unnecessary time sorting through and providing extra documents. The documents provided at this stage, generally speaking, involve matters that can be successfully addressed once they have been identified.

#### Just before Stage 5: Deal Closure

The company should upload and the DD Team review all documents related to the proposed terms (or existing terms on which other investors have been investing), along with all documents required to complete the current financing and all documents that had been used in previous financings (which will lay out the precise terms granted to those investors).



# Appendix D - Sample Questions for Reference Checks

1. How long have you known this person?
2. In what capacity did you interact with him or her and they interact with you?
3. What relevant skills and experiences does he or she bring to this position, which allows him or her to: shape the work environment and culture of this company; be resourceful in finding solutions; be adaptable; maintain effective communication; set strategy; allocate resources; develop managers; build an organization; and oversee operations?
4. What are his or her weaknesses?
5. Does he or she have a clear picture of the emerging markets and the competitive landscape in which this company operates?
6. Does he or she have a track record of demonstrated knowledge, accomplishments, and/or results in this industry that leads you to believe he or she can be successful in this venture?
7. Does he or she build good relationships with peers and subordinates?
8. Is he or she honest, dependable and someone who takes responsibility for his or her actions?
9. Has he or she had and learned from failures that might offset overconfidence and help him or her avoid making potentially costly mistakes in the current venture?
10. How do you think he or she will get along with his or her co-founders and co-executives?

# Appendix E - Deep Dive Session and Site Visit Procedures

The information in this Appendix is provided as a guideline for the type of information to gather before, and the types of subjects to cover, at the Deep Dive session.

## A. Product(s)/Service(s)

1. Workflow or process map showing how product(s)/service(s) marketed by the Company fit in targeted customer(s)' business environment: ease of introduction in existing processes, impact on adjacent processes.
2. Customer need and urgency for product(s)/service(s) marketed by the Company and how it can change over time as influenced by internal or external factors (customers' priorities, budgets, results; regulatory changes; market and/or economic shifts; etc.
3. Management's contingency plan in the event that product development and/or deployment is delayed, and an explanation of how the team will handle its planned mitigation of development/deployment or adapt ongoing development to adapt to cost overruns or delays in revenue generation.
4. Diversity of vendors vs. over-reliance on one, or very few, suppliers or vendors.
5. Diversity of customers vs. over-dependence on one, or very few, customers.

## B. Marketing/Pricing

6. Sales approach: evaluation of management's approach to reach targeted distribution channels for realism (cycle time, resources, cost, incentive/compensation ...etc.).
7. Sales cycle: discussion of concerns about potential delay in sales closures and management's plan to mitigate such.
8. Pricing strategy: discussion of realism and basis for price/value proposition; is there a ROI case to present to the customer? Is it a tactical/short-term ROI play versus a long-term strategic play and what are the implications on pricing and expected sales?
9. Planned pricing adjustments at various steps of the Company's lifecycle: trial, launch, growth, maturity; test for realism and safety margin accounted by management.

## C. Roll-Out Plan

10. Management Roll-out plan from product development to break-even: milestones; resources required (cash, human, technology ...etc.); sales targets; infrastructure implications and how the Company will address them.
11. Management specific experience in rolling out similar product(s)/service(s).
12. Management's plan to mitigate missed and/or delayed milestones in terms of a revised roll-out plan (accelerating other phases?), resources requirements (cash, human, technology) and business viability.

## D. Revenue Assumptions

13. Management's evaluation of the risk of not reaching the revenue built into financial projections: probable cause(s); influencing parties/factors.
14. Potential impact of predatory pricing from new market entrant or existing competitor(s) on the Company's projected revenues and management's plan to mitigate such (cost reduction, defense of pricing through superior value and/or quality ...etc.).

## E. Organization

15. Management compensation plans and agreements including bonus and deferred compensation agreements: discuss basis for such; review changes expected by management in near and mid-term future; ensure plan is adequate to incentivize key management to stay and to attract other required executives.
16. Schedule of employment, consulting and advisory contracts: ensure that all contracts are in place and adequate.
17. List of employees including wages/salaries/retirement plans and job description: ensure adequacy relative to job market conditions and to the Company's situation and needs.

#### F. Competition

18. Name of competitors in targeted and adjacent markets; explain their positioning relative to the Company covering their respective strengths and weaknesses; market share/revenues (actual or estimates); funding/backing; Opportunity and/or threat they each represent for the Company.
19. The Company's product positioning vs. competition: attributes and value/price comparison including projected shift along product/market maturity cycle.
20. Explain and demonstrate effectiveness of relative barriers to entry.
21. Explain and demonstrate "unfair competitive advantage" on competition.

#### G. Risk and Opportunities

22. Management's view of the risks it faces in implementing the proposed business plan its plan for how to mitigate such risk.
23. Management's assessment of additional opportunities (other markets, adjacent products/services, additional sales or improvement of pricing environment/mechanism that can be seized and potential impact on the Company's results and strength.

#### H. Finance

24. Financial projections sensitivity analysis: impact of change in assumed costs, prices, sale volumes and revenues on projected financial results; has management provided enough safety margin to achieve projected results?
25. Management plan to control costs and maintain costs them within projected range: product(s)/service(s) cost structure; overhead; sales and marketing expenditures.
26. Schedule of any material commitments or any material off-balance sheet liabilities that are considered likely to give rise to any liabilities.

#### I. Demonstration and Site Visit Questions

27. Demos and other DD items requiring an on site visit are often industry specific. Nevertheless, there are observations a Keiretsu Forum DD Team member can make that may affect an investor's interest in the Company. These include:
  - a. What is the company culture?
  - b. What (and how many) management team members were present?
  - c. Describe the work environment?
  - d. Do the office space, office furniture, computers, and other assets look appropriate for the size and capitalization of the company?
  - e. Demonstration of product(s)/service(s) in either simulation or real environment in the presence of a technology expert. Does it do what the Company says it is supposed to do? Does it work consistently (over several trials)? What factor(s) influence the proper functioning and are a failure of these factors likely to prevent successful deployment?
  - f. What is the level of security deployed by the Company to protect information and intellectual property (access policy, redundancy of systems, etc.)?

# Appendix F: Final DD Report Outline

*As a reminder, both the draft DD Reports and the final DD Report should include a standard disclaimer placed in an obvious location such as on a cover page as a method of limiting liability for the DD Leader and DD Team members. One potential example is included in Appendix K.*

The contents of both this Appendix and Appendix G are intended to provide an outline of the structure of a DD Report and the content the Report should address. Every item below is not applicable to every company.

**1. Executive Summary:** This section highlight the nature of the investment opportunity, the major pros and cons, and any glaring red-flags. This is intended to be a very short, high-level summary orienting the reader to the whole report.

**2. DD Team:** This section profiles the DD Leader and DD Team members, along with the background of any contributors outside the formal DD Team. Their background, experience, and credibility are an important context for their assessments. Provide their contact information.

**3. Process:** This section describes the process and timing of the DD process. The more interaction points between Keiretsu Forum members, entrepreneurs, and people involved in the company's progress both inside (i.e. multiple key management team members) and outside (i.e. customers, partners, vendors, other investors, and so on), the more credible the final report will be. Specify what was included in the process and make certain to point out what was excluded or left out of the process.

**4. Abbreviated Summary of Conclusions / Condensed Summary Report:** Unlike the executive summary, this is intended to be a bullet-point summary of many (but by no means all) of the key evaluators angel investors should be considering in assessing an opportunity. This should not include the level of detail, information and explanation that will be included in other sections of the DD Report. This section will end up oriented toward conclusions about key subjects. ***So, it should include a reminder that conclusions not mixed with detailed information and supporting information have a subjective element.*** Whether or not to include this section should be considered a matter of discretion, based on the level of complexity and subtlety involved in the industry and opportunity.

A summary of content to review is included in Appendix G. At his or her discretion, the author might consider using a five star ranking system for each of the categories of elements highlighted in that Appendix.

**5. Leadership Background:** This section should highlight the relevance of the company's leadership to both the industry and the challenges associated with the company's business model.

**6. Business Review:** This section makes up the bulk of the report, and should include details and specific on, at a minimum, the following subjects.

- *Sales and Customer Acquisition:*
  - Who are the company's current customers? And, which potential customers are in, and how far into, the sales pipeline?
  - What is the problem the company is attempting to solve, and what "pain" among different customers will the company's product or service address and solve?
  - What is the return customers will receive from using that product or service (i.e. how much will they spend and how much will the product increase the customer's bottom-line)?
  - How long will the sales cycle be for different customers?
  
- *Business and Revenue Models:*
  - What is the company's business model? And, what is its financial model?
  - Does the company have several different actual or potential revenue streams?
  - Does the company have actual, or potential, recurring revenue streams?
  - What is the cost of customer acquisition? What is the likely, average length of customer retention and rate of customer turnover? And, what is the anticipated life-time value of each customer?
  - How many potential follow-on products or services are planned or possible? Will these lead to a diversification among more types of customers?
  
- *Marketing Plan:*
  - What is the company's go-to-market strategy?
  - What is the market size, growth, and rate of growth? What is the company's ability to capture and generate revenue early on from (and possibly establish market dominance in) a strong beachhead market within the overall, total addressable market?
  - What is the assessment of the strength of the competition? Who else is out there (currently and potentially) in similar and different categories? What are the company's barriers to entry against competitors? What is the company's ability to use follow-on products or services to expand as competitors enter the market?
  - Value Proposition: Why would informed target customers be wise to buy this product or service? What is the distinct competitive advantage?
  - Go-to-market plans: How does the team plan to lead the company to increased profitability and adapt to resistance or failed assumptions with alternative go-to-market plans?
  - Current Customers & Revenue: What success and traction does the company already have?
  - Customer and partner interviews: What do current customers and prospects say about the company, product or service, and leadership team relative to the other choices in the market? What do they say about how valuable the company's product or service will be for the customer's business? This is meant as a summary of the conclusions drawn from these interviews. More detail on the specific content of these interviews will be included later on in an Appendix to the core of the DD Report.
  - Does the marketing plan, and do the barriers to entry, depend on the company's financial ability to enforce intellectual property or the speed with which the company can implement its go-to-market strategy and build a brand?
  
- *Technologies or Products:*
  - What technologies have been developed, chosen, or deployed?
  - What technology architecture was used?
  - How proven is the technology? What technology risks are there?

- What is unique and differentiated about the product that will give the company a competitive advantage?
  - What additional or follow-on products are under development?
  - What intellectual property does the company possess, or is branding or being first to market more important than intellectual property for the company (which should also be discussed and considered as part of the section on the marketing plan)?
  - How does the company's intellectual property benefit its business and revenue models?
- *Operations & Execution:*
    - From where does the company source the components of its product and how reliable are the vendors?
    - Has the company established a redundancy among its vendors and put in place a backup plan that can be implemented quickly if there is a problem with a vendor?
    - Where does the company manufacture its products?
    - What issues might the company face with its manufacturers or suppliers?
    - Is purchase order financing, if relevant, already in place or available to prevent the company from having to use investor capital for inventory?  
How does the company handle or plan to handle logistics and distribution?
    - What in-house or outsourced plans and procedures does the company have in place for both sales-support and customer support?
- *Real Estate:*
    - In the case of real estate investments, what are the qualitative market dynamics and trends, including business activity, public sector efforts to promote business growth and development, demographic trends, and other factors that support quantitative data on projected changes in prices in the local market?
- *Management and Advisory Team:*
    - What is the DD Team's assessment of both the relevance of the management team's backgrounds to the industry and applicability to the challenges associated with the company's business model?
    - What is the DD Team's assessment of what the management team has learned from both its previous successes and, perhaps more importantly, from its previous failures?
    - What did the DD Team learn about the management team in its background and reference checks?
    - How do members of the co-founding team appear to get along with each other? How do members of the company's broader management team appear to get along with each other? What is the DD Team's assessments of the personalities of all the key players involved in launching the company successfully?
    - Is the Board structured in a way that balances control and influence between the founders and investors, and among the different classes of shareholders?
- *Financials:*
    - What conclusions did the DD Team draw from reviewing the company's historical P&L, current balance sheet, cash flow, cash on hand, and relationship in the company's financial model between its core assumptions and its projections?
    - What is the company's past financing history, in terms of all of amounts, sources, timing, and terms?

- Are there any foreseeable problems that might arise due to the structure of, and people or investors on, the company's capitalization table?
- Are there any foreseeable problems that might arise due to the terms of previous financings?
- *Other:*
  - Every company will have unique elements that are related to that company's potential for success or risk of delay or failure. Each DD Leader or DD Report author should use his or her judgment as to what else should be covered in this section of the DD Report.

**7. Strategic Assessment:** This section essentially provides a detailed analysis of the facts underlying what the management team must do to succeed, given the challenges it faces and the advantages it has going for it. Put more casually, this section describes in detail the factual headwinds and tailwinds, and whether or not the team seems prepared to navigate from the rough waters ahead to the type of smoother waters where their boat is most likely to perform well.

- What customer validation has the company achieved or obtained?
- What are the company's future milestones and what resources are necessary to achieve them?
- What is the DD Team's assessment of the key risks?
- What are the top five strategy issues, elements, or "bets" that investors need to believe to want to invest?
- What are the business projections, key underlying assumptions behind the financial model, and early evidence to support these projections?
- Are there any major red-flags about the company?
- Are there any identified deal breakers about the company's strategy relative to what Keiretsu Forum members would expect to be essential to success (i.e. are members going to choose not to invest because they will fundamentally disagree with the company's approach)?
- What are the barriers to entry (related to each of the company and the industry)?
- How strong or weak are the barriers to entry?
- Could another company duplicate the company's offering? If so, how fast and how inexpensive would it be for another company to achieve this?
- Is intellectual property a factor in the company's success, or is branding and time to market more essential than intellectual property?
- How realistic is the company's assessment of its exit strategy, and what evidence does it have to support its assessment?
- Are there any legal actions against the company that are, or might be, pending, threatened, likely or, perhaps most importantly, foreseeable?
- What is the company's vulnerability to running out of cash before the next major financing can be completed?

## **8. Valuation and Terms:**

- What is the DD Team's assessment of the management team's financing, negotiating or structuring experience?
- What are the potential risks, or foreseeable risks, to investors of the deal's proposed terms?
- If the company is using an equity instrument, what is the DD Team's assessment of the combination of valuation, projected dilution in a worst case scenario, preferences to different classes of shares, and comparable exit multiples on potential investor ROI?

- If it is using a convertible debt instrument, what is the DD Team’s assessment of the relationship between the company’s current status and progress to date and the worst-case scenario if progress comes slowly?
- Especially if progress comes slowly or the company runs short on cash, how is a future lead investor in an eventual equity financing likely to value the company?
- Whichever type of instrument the company is using, what is the assessment of the DD Team’s members as to what the company’s cash on hand and negotiating position will be at the time the next equity financing closes? What impact might that negotiation have on existing investors at that time?
- What is the company’s pre-money and post-money valuation?
- What is the allotment in the current financing for Keiretsu Forum members?
- What is the planned use of proceeds?
- What is the company’s burn rate?
- What resources and amount of financing are truly necessary to meet different objectives?
- How negotiable is the company’s leadership?

#### **9. Company Structure and Financing History:**

- What is the company’s financing history?
- How much of the company is held by the founders, management team, employee option pool, and investors in different, previous rounds of financing?
- How does the DD Team believe the balance between the founders and previous investors will affect the long-term control of the company and potential near or long-term changes in who is (or will be) leading the company?
- Are there any provisions of concern in the terms of prior financings that will limit the rights of investors investing based on the proposed terms of the current financing?

**10. Company Responses to Questions:** Either within the report as a section toward the end or as an Appendix to the Report, the DD Report should include key highlights of how the company responded to both the initial questions in stage 1 and the supplemental questions in stage 2. The company’s written responses can be included as an Appendix to the DD Report. Additionally, the DD Report’s author might include a filled in summary of how the Company responded to the industry specific questions in Appendix J to this Handbook. *These should be filled in by a member of the DD Team, not by someone from the company.*

**11. Summary of Key Verifications:** Either within the report or as an Appendix to the Report, the DD Report should include a summary written by the members of the DD Team involved in some of the key verification discussions. These should include conversations with key references, key customers, vendors, partners, current investors, other investors currently conducting DD that would be co-investors with Keiretsu Forum members, and so on.

**12. Documentation Checklist:** This section should include a summary of what documents were reviewed (incorporation, employment, vendor contracts, patents, etc.) to ensure that they are in place, or to confirm that the company’s statements about its proof of concept and traction with customers and partners. In addition to, or instead of, this summary, the DD Report might include a filled in copy of Appendix H (Document Binder) to this Handbook, along with a list of what other items in addition to those on that list were provided and reviewed. If the company is still in the DD process in stage 5, all of these documents should have been uploaded to the company’s Gust Deal Room for review by interested investors.



## An Important Note on Data Room Access

*If the company has a data room or data vault hosted somewhere other than within Keiretsu's Gust Group for that company, then the link and password to that data room should be posted within the Gust Group in an easy to notice location.*

**\*\*\* The Data Room's password should NOT be placed in the DD Report. \*\*\***

*This will enable the URL and password to only be available to people with a Gust user name and password who have been invited to the company's Gust Group by The Keiretsu Team. The DD Report can inform readers to look within the Gust Group for access information. A DD Report, after having been downloaded from a Gust Group, may end up circulated by email or in print form, and the company will understandably want to control access to its documents.*

## Use of Gust Groups and Data Rooms vs. Including Company Documents in DD Reports

Please bear in mind in writing a DD Report that all of the company's information and documents do not need to be provided as attachments to a DD Report. Those documents should all have been uploaded to the company's Gust Deal Room. A DD Report is not meant to be ... or even to include ... a compilation of materials provided by the company, and generally should not include what the company provides. Rather, it should include what the DD Team gleaned from drilling down into the company's materials. The DD report is a summary of how the DD process was conducted, what information surfaced (as distinct from what information was provided by the company), and what assessments and conclusions were reached by the DD Team conducting DD and the industry experts to which they turned to for feedback.

When the Founding Region's Due Diligence Committee recommended and implemented the switch to using Gust, the Committee's objective was to implement a combined flow of pipeline tracking, due diligence process monitoring, data tracking, member communication, scheduling, and document sharing. The chapters that use other platforms are also focused on coordinating DD processes and adding project management, along with facilitating inter-chapter coordination.

Keeping documents in a central data room is part of both facilitating inter-chapter syndication and accelerating the process of conducting due diligence in follow-on financings. It enables DD Teams to update information to reflect company progress without having to essentially start from scratch.

# Appendix G: Quick Summary for within Final Report

It is highly recommended that the DD Leader step back before writing the final DD Report and complete a *condensed summary section* for possible insertion into the Report. The preparation of this summary section is intended to provide an opportunity for the DD Leader to take a step back from the process, crystalize his or her thoughts at a macro rather than micro level, and focus in on the key conclusions.

Based on all the dynamics and factors related to the company and its industry, a DD Leader should carefully consider whether it might be more beneficial or potentially more harmful to actually include a summary like this in a DD Report.

If used, this section is intended to provide an abbreviated “report within a report” for busy people. However, both DD Leaders and Keiretsu Forum members should remember that a summary like this will invariably be subjective in nature, even if the DD Leader and DD Team conducted a very thorough and exhaustive DD process.

If used, the title should be something along the lines of “***Abbreviated Summary of Conclusions Drawn within the Due Diligence Report: Strengths, Weaknesses, and Red-flags***” OR **Condensed Summary Report: Strengths, Weaknesses, and Red-Flags.”**

And, it is very important to include a reminder analogous to the following: “*Though this summary section is based on an attempt at an objective, factual analysis, it does represent the subjective conclusions drawn by its author as a result of the analysis conducted by the DD Team.*”

The Structure should be a simple list, for each set of elements below, of:

- Strengths,
- Weaknesses,
- Unanswered Questions,
- Concerns, and,
- Major Red-Flags.

The topics to consider and address should include the following.

**1 - Market/Space/Sector:** Clear problem? Clear pain? Competition? Exit Comparables in the industry? Valuation of public market comparables? Current rate of growth in the sector? Projected increase in rate of growth in the sector? Publicity about the industry?

**2 - Marketing and Sales:** *Business Plan (or business model canvas)? Financial Model? Product/Service? Sales Cycle? Customers? Barriers to Entry? Potential Follow-on Products? Size, demographic, and buying-habits of initial beachhead market? Additional markets for expansion? Overall market potential?*

**3 - Technology:** Conclusions of the person or people conducting technology DD? Testing and verification? CTO & VP of Technology's ability and management skills? Engineering costs? Platform adaptability and stress loading upon deployment and ramp-up?

**4 - Execution Plan:** Solid revenue Driver? Scalability? Defensible IP?

**5 - Traction:** Customer buy-in to business model, product or service? Customer satisfaction? Sales Approach? Sales Cycle?

**6 - Management:** Is the team complete? Relevant experience? Track record? Wisdom, persistence, & personality? Flexibility and adaptability? Effective interactions with investors? References and background checks? All key senior executives have thought through how to deal with potential challenges to execution plan?

**7 - Board of Directors & Board of Advisors:** Relevant experience? Contacts?

**8 - Existing Investors:** Friends and Family? Angels? VC? Strategic Investors? Customers have invested? Unique Capital Terms? Potential participation of existing investors in follow-on financings?

**9 - Investment Required & Deal Terms:** Status of current Investment? Proposed Deal Terms? Burn-rate? Timeline to profitability? Valuation? Projected and probable dilution? Ownership? Concerns of legal counsel about key terms in term sheet and stock purchase agreements? Probability of harmful terms or cram-down by follow-on investors due to amount of follow-on financing required and specific execution plan risks? Corporate Documents in place and up to date?

**10 - Operations:** Supplier and Vendor Relationships? Ability to obtain non-dilutive debt financing? Payment terms with customers and vendors? Amount of capital required for inventory)?

**11 - Financials:** Proper balance sheet? Robust financial model? Bottoms-up, flexible financial model that integrates all key assumptions? Financial model based on grounded assumptions? Corporate Structure in place?

**12 - Revenue Potential:** Pricing Model? Pricing Changes Over Time?

**13 - Profitability:** Current Revenue? Current Burn Rate?

**14 - ROI Potential:** Risks and Opportunities?

*“Great Association with Quality Deal Flow”*

KEIRETSU



FORUM

**Due Diligence Handbook Appendices**

**Company Information**

# Appendix H - Company Overview

Ask the entrepreneur what information below is immediately available and what will take more time to produce. Ask the entrepreneur to post material that is readily available, and will not take excessive time to gather, immediately. Review the recommendations in Appendix C (regarding the recommended sequence for requesting documents) and determine up front what remaining material will be required.

## Corporate Structure/Organization

1. Founding information: date, founder(s)
2. Legal structure: type of corporation, certificate(s) of incorporation, list of states/countries in which the Company is authorized to do business
3. Current By-laws (including all amendments)
4. Agreements related to significant acquisition(s) or disposition(s) made by the Company in the last 3 years.
5. Company organization: Organization chart, FTEs; consultants/ service providers (including legal); outsourced functions and relevant contracts

## Funding/Ownership

6. Funding raised: Capitalization table including capital raised to date, form/structure(s) including bridge loan(s) valuation, funding sources and relationship/commitments to the Company, contact information

## Proposed Deal

7. Current round of financing: amount expected, timeframe, expected use of funds, expected milestones, shortfall contingency plan
8. Planned next round of financing: targeted capital sources, amount required, expected use of funds, expected milestones
9. Company valuation: current valuation, basis for valuation, industry comparables for both valuations and exit multiples, and company's financial model and underlying assumptions as they related to future valuation

## Financial Structure

10. 3 years Historic financial statements: Balance Sheet, Income Statement, Cash-flow (audited if available)
11. Schedule of all liens and encumbrances against assets/stock
12. Schedule of all the Company's investments
13. Copies of all federal, state, local and foreign tax returns for the current year and past three years

## Financial Model

14. Historical and current financial model: debt, cash-flow, burn rate, income, balance sheet
15. Margin: gross, operating, net each product/service; expected trend over time & product cycle
16. Projected financials: cash-flow and income projections for next 3-5 years
17. Assumptions driving projected financials: market share/penetration; price; revenue model; sale and payment cycles; cost of goods/services; overhead; ...etc.

### Product/Service

18. Expected time frame and milestones to reach commercialization
19. Product marketing materials, including product, pricing & customer list(s), marketing collateral
20. Status of product(s)/service(s) development cycle (pre- $\alpha$ ,  $\alpha$ ,  $\beta$ , commercial trial or launch...)

### Customers

21. Existing customer(s) and nature of relationship: names, contacts & their position; targeted sales volumes & revenues for top 10 customers
22. Customers' pipeline
23. Letter(s) of intent from potential customer(s)

### Suppliers

24. All suppliers critical to development, procurement, deployment & servicing of product(s)/service(s)

### Marketing

25. Most relevant & recent press releases; coverage of Company, target market, competitors & customer

### Tax Matters

26. Suitability for taxable or retirement investment based on risk profile (subjective)
27. Is this income or capital appreciation type of investment
28. Capital gains should be disclosed to the extent projectable
29. Tax credits should also be relatively certain depending on the investment
30. UBTI (Unrelated Business Income Tax) should be fairly cut and dry but we should request an outside tax firm's opinion from the sponsor

# Appendix I - Document Binder

The list of items below does not reflect a complete list. Items should be added based on the Company in question and the analysis of the DD Team. This list is intended to save the entrepreneur and DD Team time by providing the entrepreneur up front guidance as to what documents should be gathered.

There is no need to attach these documents to a Final DD Report. These should be uploaded by the entrepreneur to the Deal Room component of the Gust Group for the company to which the entrepreneur has access. One member of the DD Team should be assigned to review all of the documents.

## Corporate

Certificate of Incorporation and all related documents:

1. Certificate of Incorporation and related documents .....  *Pending*       N/A     Provided
2. Articles of Incorporation .....  *Pending*       N/A     Provided
3. By Laws .....  *Pending*       N/A     Provided
4. Shareholder Agreement .....  *Pending*       N/A     Provided
  
5. Schedule of all business entities, which comprise, or are affiliated with the Company  
 *Pending*       N/A     Provided
  
6. Stockholder Agreements .....  *Pending*       N/A     Provided
7. Options Plan, rights of first refusal .....  *Pending*       N/A     Provided
8. Voting trust Agreements .....  *Pending*       N/A     Provided
9. Warrants Agreements .....  *Pending*       N/A     Provided
  
10. Any other agreements with respect to ownership of the Company or relating to rights to purchase the capital stock and/or assets of the Company     *Pending*       N/A     Provided
  
11. Agreements, documents or closing volumes related to any significant acquisitions or dispositions made by the company during the last three years or which are currently proposed  
 *Pending*       N/A     Provided
  
12. List of current officers and directors of the company and all employees and consultants of the company. ....  *Pending*       N/A     Provided
  
13. Internal operation manuals, all policy manuals, including those related to hiring, regulatory compliance, internal controls and internal policy statements of the company  
 *Pending*       N/A     Provided
  
14. Closing volumes and any other agreements or documents relating to any secured or unsecured borrowings of the company, including any debt instruments, debt/equity exchanges, letters

- of credit, sale and leaseback transactions, guarantees, pledges, security agreements and any other documents relating to liens and security interests...  Pending  N/A  Provided
- 15. Bonds or other government financing programs. ....  Pending  N/A  Provided
- 16. All material correspondence with lenders including correspondence related to refinancing of any the company debt. Need to review and summarize any loan agreements  
 Pending  N/A  Provided

## Finance

- A summary of any loans, guarantees, performance bonds, and/or cash infusions of any officer, director or stockholder of the company or any other related party and amounts and terms of such loans or transactions .....  Pending  NA  Provided
- Financing for specific facilities of the company, including documents and agreements evidencing equipment and vehicle financing arrangements. ....  Pending  NA  Provided
- Schedule of all liens and encumbrances against any of the Company’s assets or stock  
 Pending  NA  Provided
- Any correspondence with creditors or Companies during the last two years not in the ordinary course of business .....  Pending  NA  Provided
- Schedule and documents supporting loans and loan guarantees ..  Pending  NA  Provided
- Schedule of all investments related to the business of the company  
 Pending  NA  Provided
- Schedule of all bank accounts and safe deposit boxes of the company  
 Pending  NA  Provided
- Audited financial statements for the past three years .....  Pending  NA  Provided
- List of all current inventories including location of inventory .....  Pending  NA  Provided
- Detail list of all tangible property and equipment including location  
 Pending  NA  Provided
- Detail list of current Accounts Payable and Accounts Receivable aging  
 Pending  NA  Provided
- List of all products and services offered and their pricing .....  Pending  NA  Provided
- Description of financial and management information systems and related contracts with outside vendors if applicable .....  Pending  NA  Provided



Current and future years Budget and strategic plans .....  Pending  NA  Provided

## ***Taxes***

Copies of all federal, state, local and foreign tax returns for the current year and past three years  
.....  Pending  NA  Provided

Copies of memoranda and other documentation relating to the company's income or other tax liability or prepared in connection with any tax problems affecting the business of the company since inception or which may rise in the future .....  Pending  NA  Provided

Copies of all state sales and use tax reports and returns of the company for the current and past three years .....  Pending  NA  Provided

A schedule describing any ongoing tax disputes with copies of documentation with respect to pending federal, state, local or foreign tax proceedings with regard to open items.  
.....  Pending  NA  Provided

## ***Employee Relations***

Management compensation plans and agreements including bonus and deferred compensation agreements .....  Pending  NA  Provided

Employee stock option plans  
.....  Pending  NA  Provided

Documents assigning the rights to patents from the creators to the company  
.....  Pending  NA  Provided

Employment, consulting and advisory contracts .....  Pending  NA  Provided

Summary of employees including wages/salaries and job description  
.....  Pending  NA  Provided

Employee background investigations and degree verification documents  
.....  Pending  NA  Provided

Pension and retirement plans and all related plan documents. ....  Pending  NA  Provided

Management & consulting agreements, agreements not to compete, agent agreements, confidentiality agreements with employees, & agreements with employees covering inventions  
.....  Pending  NA  Provided

Key man life insurance plans or other death benefits .....  Pending  NA  Provided

All correspondence and documents received from and filed in the last three years with relevant employee relations, occupational safety and civil rights organizations

Pending     NA     Provided

Schedule and brief description of all pending legal or arbitration proceedings

Pending     NA     Provided

All employee manuals, handbooks, policy statements, payroll practices and personnel practices

Pending     NA     Provided

Acquisition or divestiture agreements affecting any Qualified Plans

Pending     NA     Provided

Any other material agreements or documents relating to employees, consultants or agents of the company.....  Pending     NA     Provided

Insurance Policies including product liability, E & O, D & O, liability limits etc.

Pending     NA     Provided

Name of broker \_\_\_\_\_

## ***Contracts and Commitments***

Material &/or long-term contracts and purchase orders w/customers & suppliers

Pending     NA     Provided

All government contracts.....  Pending     NA     Provided

Material and/or long-term equipment, automobile or other leasing contracts

Pending     NA     Provided

All management or service contracts for the sale of services related to the business of the company

Pending     NA     Provided

Agreements requiring the company to indemnify or hold harmless any other person

Pending     NA     Provided

Agreements related to waste disposal and environmental services

Pending     NA     Provided

Any other material and/or long-term contract related to the products, services or business of the company.....  Pending     NA     Provided

Information services and data processing agreements, including lists of software and licensing status

Pending     NA     Provided

All requirements or take-or-pay contracts.....  Pending     NA     Provided

All warranties and service contracts.....  Pending     NA     Provided

All license agreements .....  *Pending*      NA      Provided  
All distribution and distributorship agreements .....  *Pending*      NA      Provided

## *Property*

Deeds held by the company and options to sell or purchase real property  
.....  *Pending*      NA      Provided

Original real property leases and all amendments thereto .....  *Pending*      NA      Provided

Easements, licenses and restrictions on use relating to real property related to the business of the company.....  *Pending*      NA      Provided

Title insurance policies & surveys relating to real property related to the company  
.....  *Pending*      NA      Provided

Maps and blueprints of all buildings and property of the company  *Pending*      NA      Provided

Appraisals on any owned real property.....  *Pending*      NA      Provided

Schedule of material personal property owned & related to the business of the company  
.....  *Pending*      NA      Provided

## *Governmental Licenses, Permits and Filing*

Federal licenses, permits or clearances related to the business of the company if applicable  
.....  *Pending*      NA      Provided

State, county, and city licenses, certificate of occupancy, and environmental-related permits related to the business of the company .....  *Pending*      NA      Provided

All other licenses, certificates and letters of accreditation .....  *Pending*      NA      Provided

Policies related to the treatment, storage and disposal of hazardous waste and other waste products  
.....  *Pending*      NA      Provided

## *Intellectual Property*

Schedule of patents, trademarks, service-marks, trade-names, copyrights and other agreements used or held in the name of the company.....  *Pending*      NA      Provided

Documents regarding any claim of infringement of the intellectual property rights of Companies and any claims against the company alleging any such infringement ..  *Pending*      NA      Provided

Any other material intellectual property rights or claims.....  *Pending*      NA      Provided

## *Insurance*

Schedule and description of all insurance policies now in effect ..  *Pending*     NA     Provided

Copies of all insurance policies in effect and certificate of insurance for each policy  
 *Pending*     NA     Provided

Loss and/or claims history for all such insurance coverage's maintained for company, past five years  
 *Pending*     NA     Provided

## *Litigation and Regulatory Compliance*

Copies of all material correspondence or notices concerning compliance with occupational safety, civil rights, labor or environmental laws .....  *Pending*     NA     Provided

Consent decrees, judgments, settlement agreements and other agreements to which the company is bound, requiring, regulating or prohibiting any future activities ..  *Pending*     NA     Provided

Schedule and brief description of all pending legal or arbitration proceedings to which the company is a party and the names of the court or agency in which the proceedings are pending  
 *Pending*     NA     Provided

Schedule of potential or threatened government investigations and legal proceedings and any other contingent liabilities of the company .....  *Pending*     NA     Provided

All material correspondence with respect to any administrative or regulatory body which regulates the business of the company .....  *Pending*     NA     Provided

Audit response letters from all outside legal counsel to the company, past three years  
 *Pending*     NA     Provided

The material in this Appendix was initially created by members of The Keiretsu Forum's Founding Chapter in the East Bay of the San Francisco Bay area during the first two years after The Keiretsu Forum was founded in 2000.

# Appendix J - Industry-Specific Questions

These questions relate to specific industries/products/services and are provided to the DD Leader for use as it may apply to the Company being evaluated for investment. Contact should be established with Keiretsu Forum members with specific knowledge and experience in these areas in order to build a list of the specific, additional questions most appropriate to the Company.

## Software

What is/are the platform(s) on which the Company's application(s) are being written? How current is it and how much of a future does it have compared to others?

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Does the company have the adequate licensing arrangements in place for use of coding language(s) or other proprietary platform tool? Are there any expected changes in these arrangements in the foreseeable future and how would they impact the Company's product(s) and its viability?

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How has the application(s) been tested so far? Results of such tests? Resulting action plans (streamlining, re-coding, etc.)?

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What is/are the next testing milestones and when do they expect to be reached?

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Is management team experienced in testing and launch of software applications? Describe specific experiences and how they apply to the particular application being launched?

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How compatible is the application with the platform commonly used by targeted customers? Has compatibility been tested? If yes, what were the findings and resulting action plans?

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What is the functionality of each application release version and how does it compare with expected requirements from targeted customers?

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How easy is it to customize the application to meet specific and/or changing customer needs? Is customization required by targeted customers and to what level?

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What would it take for competitor (existing or new) to develop a similar application in terms of specific expertise and resources (human, capital, time) required?

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## Hardware

What is/are the technology(ies) used in the design and manufacturing of each hardware component marketed by (Company)?

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Has (Company) made the proper arrangement for use of others' technology(ies) in its product(s)? How are these arrangements expect to change and how would these changes impact the Company's viability?

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How has the hardware component(s) been tested so far? Results of such tests? Resulting action plans (re-design, improvements, etc.)?

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What is/are the next testing milestones and when do they expect to be reached?

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Is management team experienced in testing and launch of hardware applications? Describe specific experiences and how they apply to the particular hardware application being launched?

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How compatible is the hardware with the platform(s) or hardware commonly used by targeted customers? Has compatibility been tested? If yes, what were the findings and resulting action plans?

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What is the functionality of each historic and planned hardware release and how does it compare with expected requirements from targeted customers?

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How easy is it to customize the hardware component(s) to meet specific and/or changing customer needs? Is customization required by targeted customers and to what level?

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What would it take for competitor (existing or new) to develop a similar application in terms of specific expertise and resources (human, capital, time) required?

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## Life Sciences-Biotechnology

Meet at (Company) to review facilities for laboratory and manufacturing work (if applicable) and assess adequacy for product(s) developed and/or being launched.

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What is the status of product/application testing? What is the Company's planned testing plan and are resources adequately planned for each phase (human, materials, capital, time)?

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If required, what is management team's experience with clinical trials and FDA approval process and how does it apply to this specific trial?

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If (Company) has already started and/or completed clinical trial(s), what is/are the protocol(s) and result(s) to date? What is/are the next set of expected result(s)?

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What is the Company's vendor qualification policy and process and how does it tie to the quality and consistency of the Company's product(s)?

## Telecommunication - Wireless

What is/are the platform(s) on which the Company's product(s) are being developed and how does it work with the prominent platform(s) used by targeted customers?

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What is the status of product/application testing? What is the Company's planned testing plan and are resources adequately planned for each phase (human, materials, capital, time)?

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What are the hardware and software implications for targeted customers (upgrade, switch to other platform, ...etc.)?

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Are there any anticipated interference with customers' existing infrastructure that may prevent or slow down (Company)'s product launch and adoption (IR (infrared) interferences with POS (point of



sale) infrastructure for ex.)? How has (Company) evaluated this risk and how does it plan to mitigate it?

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If consumers' adoption is critical to (Company)'s product(s)' success, has there been any focus group or similar research to quantify consumers' interests and obtain consumers' concerns? Results of such and resulting action plan?

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What is the status of (Company)'s relationship(s) with required partners: wireless carriers, phone/hardware manufacturer, retailers, others. What is the Company's exposure if one such relationship does not materialize or changes in a significant manner?

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## Real Estate

What is/are the history of the property(ies) being acquired and/or marketed by (Company)? Ownership, classification, work/development performed, previous use for similar or other activities, historic utilization and rates...etc.

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What the environmental status of the property? Any clean-up required before permit for planned use can be issued and, if yes, what is the anticipated cost and timeframe for such clean-up? Is risk-based clean-up an accepted option for the property and its intended use?

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Who will manage the property during development and commercialization phases and what is their respective experience in doing so?

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What is the status of all permits required for intended use of property?

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What are the terms (rates, term, and significant provisions) of lease(s) with existing tenant(s) and how likely are renewals (and at what terms)?

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What are the expected running costs for property and how does it compare with other similar property(ies) also run by (Company)? How does it compare with industry standards with similar property(ies)?

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The material in this Appendix was initially created by members of The Keiretsu Forum's Founding Chapter in the East Bay of the San Francisco Bay area during the first two years after The Keiretsu Forum was founded in 2000.

*“Great Association with Quality Deal Flow”*

KEIRETSU



FORUM

**Due Diligence Handbook Appendices**

**Supporting Information**

# APPENDIX K - Keiretsu Forum Application and Investment Processes

This Appendix is intended to provide a brief overview of how The Keiretsu Forum functions within the broader scope of angel investing and how The Keiretsu Forum's process works. This Appendix is intended primarily for the benefit of entrepreneurs considering presenting to The Keiretsu Forum and, secondarily, as an orientation to brand new Keiretsu Forum members.

***The content of this Appendix was written and provided by The Keiretsu Forum's Team.***

## **About The Keiretsu Forum**

The Keiretsu Forum was founded in 2000 by [Randy Williams](#) in the San Francisco Bay Area. The Keiretsu Forum has grown to become the World's largest angel investor network with 27 chapters on three continents and 1,100 accredited investor members. Keiretsu Forum members provide early stage capital in the range of \$250k-2 million in high quality, diverse investment opportunities and collaborate in the due-diligence, but make their own individual investment decisions. Through the collaborative Keiretsu Forum chapter network, companies have numerous opportunities to raise capital and receive resources as their companies grow.

## **The Keiretsu Forum Angel Capital Expositions**

In addition to investor Forums, The Keiretsu Forum also provides periodic Angel Capital Expositions. These are intended to be a broader gathering of the angel capital community in a region, bringing together investors and entrepreneurs looking for funding. The Angel Capital Expo is organized by Keiretsu Forum and was created to foster collaboration among angel groups, as well as reach out to the larger investment community. Attendees generally include over 300 investors and feature about twelve high-quality, diverse investment opportunities in technology, healthcare/life sciences, consumer products, real estate, and funds. An exhibition hall with booths is provided and, at many expos, a small group of pre-revenue companies will also make short presentations.

## **About Angel Investing In General**

The term "angel" originally came from England where it was used to describe wealthy individuals who provided money for theatrical productions. The term Angel Investor appears to have come into common usage in the late 1970s when the founder of its Center for Venture Research completed a study on how entrepreneurs raised seed capital in the USA.

## **Who are the angels?**

The angels are:

- Successful business people
- Invest their own money
- Long-term investors (usually 5-7 years)
- Enjoy advising/assisting entrepreneurs
- Seek a return commensurate with the risk
- Invest alone or in angel organizations

Angel Investors meet certain minimum levels of wealth and income as defined by Regulation D of the Securities Act of 1933 in order to provide exemptions from registrations.

## **About Organized Angel Investment Groups**

The first organized group of angel investors in the U.S. is the Band of Angels, which was formed in 1994. From 1996 to 2007, the number of angel organizations in the United States increased significantly from an estimated 10 to over 250 groups. This growth occurred because individual angel investors found many advantages to working together — better investment decisions, enhanced deal flow, the ability to combine their funds into larger equity investments, and group social attributes. For more information visit the Angel Capital Association web site <http://www.angelcapitalassociation.org/>.

## **Origin of The Keiretsu Forum's Name**

Keiretsu is a Japanese term describing a group of affiliated corporations with broad power and reach. Keiretsu Forum is described as a conglomeration of individuals or small companies that are organized around private equity funding for mutual benefit. Keiretsu Forum believes that through a holistic approach that includes interlocking relationships with partners and key resources, they can offer an association that produces the highest quality deal-flow and investment opportunities.

## **Key Pillars of The Keiretsu Forum**

1. Angel Investing
2. Mentoring and Resources
3. Education for both angel investors and entrepreneurs
4. Community Building and Charitable Giving

## **Mission Statement**

Our mission is “Great Association with Quality Deal Flow”.

## **“Great Association...”**

**Members:** Keiretsu Forum membership is comprised of serious investors, venture capitalists, corporate/institutional investors and serial entrepreneurs. Membership is by invitation only. Keiretsu Forum is not a fund and does not invest as an LLC. Members collaborate on due diligence, but make individual investment decisions.

**Chapters:** Keiretsu Forum has 27 on 3 continents. Our network of chapters enables:

- Support of our portfolio companies and presenting entrepreneurs with equity and resources in different geographic capital markets,

- Additional quality deal flow for our members in different geographical locations, and for
- Members to enjoy collaborative business and social relationships between chapters.

**Education:** The objective of The Keiretsu Forum Academy for investors is to better educate our members on private equity investing. Monthly meetings cover topics such as the pitfalls of angel investing, term sheets, company valuations, deal structuring and terms of financing.

### *...With Quality Deal Flow”*

**Entrepreneurs:** Our quality and diverse deal flow comes from our community of members, venture capitalists, sponsors, incubators and universities. Keiretsu Forum members invest in investment opportunities that focus on software, health care/life sciences, real estate, telecommunications, media/entertainment, automation and instrumentation, food & beverage, consumer products, clean technology, socially responsible ventures and other sectors with high growth potential.

**Resources:** at The Keiretsu Forum meetings, the presenting entrepreneurs have exposure to over 100 potential investors, as well as, resources, customers, board members, advisors, referrals, feedback.

**Education:** The goal of The Keiretsu Forum Academy for CEOs is to enable our CEOs to lead and grow their companies even more effectively. The Academy delivers valuable resources, provides learning experiences and facilitates CEO interactions. Participation is by invitation only and it is extended to CEO’s of companies that have received member funding in the prior year. Faculty members include business leaders, academics, our sponsors and members.

### **Key Differentiators**

1. We are a global network of capital, resources and deal flow with chapters in the United States and internationally.
2. Our members invest in a myriad of opportunities including “brick and mortar” i.e. real estate. 70% of our investments are in technology companies and 30% in non-technology opportunities.
3. Keiretsu Forum is a giving organization as shown by its proactive Keiretsu Forum Charitable Foundation giving environment.
4. Fellowship is enhanced not only through the charitable activities but also through countless fun activities for and by the members, such as golf, tennis, hiking, educational field trips, to name a few.
5. Keiretsu Forum enjoys open architecture and collaboration with other angel forums and investment communities that exist throughout North America.

### **Keiretsu Forum Chapters**

The network of Keiretsu Forum chapters as of September 2013 includes:

- East Bay, CA – September, 2000 (Founding Chapter)
- Westlake Village, CA–January, 2003
- Long Beach/Orange County, CA –September, 2003
- Silicon Valley, CA –October, 2004
- Los Angeles, CA –January, 2005
- San Diego, CA – January, 2005
- Seattle, WA – September, 2005
- San Francisco, CA – September, 2005

- Kirkland, WA (Formally Bellevue) – September, 2006
- Beijing – November, 2006
- Boise, ID – January, 2007
- Barcelona – October, 2007
- London – October, 2007
- North Bay, CA – October, 2007
- Portland, OR – January, 2008
- Paris – September, 2008
- New York – March, 2009 (merged into Mid-Atlantic region in March, 2013)
- Madrid – September, 2010
- Shanghai – September, 2010
- Philadelphia, PA – March, 2011
- Washington, D.C. Metropolitan Area – July, 2011
- Pittsburgh, PA – March, 2012
- Istanbul – September, 2012
- Vancouver – September, 2013
- Pittsburgh, PA – March, 2012
- Toronto – March, 2013
- Tel Aviv – June, 2013
- Singapore – In Development

## **The Keiretsu Forum’s Investment Process**

### **1. Entrepreneur Application**

Companies that apply to Keiretsu Forum are typically in their A or B rounds, usually with \$500K to \$1.5M friends and family investments. Interested companies complete the Fact Sheet available on The Keiretsu Forum web site. The on-line application is available on our website.

### **2. Committee Review**

Candidate companies are pre-screened by an adequate industry-specific committee. 2-5 Keiretsu Forum members pre-screen the company on the phone. Based on member recommendation, each month 7-10 applicants are scheduled to present at the Deal Screening.

### **3. Deal Screening**

At the deal screening 7 to 10 companies give a 15-min presentation (7-min core presentation followed by 8-min Q&A). After each presentation there is discussion on each company and the Screening Committee (25-30 Keiretsu Forum members) anonymously votes on a scale from 1 to 6 (where 1 is worst and 6 best). At the end of the deal screening the companies that ranked highest are selected to present at the full Forum.

### **4. Keiretsu Forum meeting**

The companies that are selected at the Deal Screening present at The Keiretsu Forum meetings. Usually 4-5 companies give a 20-min presentation (10-min core presentation followed by 10-min Q&A). After

each presentation, interested investor members sign in on an Interest List/Gold Sheet. At the end of the meeting, entrepreneurs are excused and Forum members have discussion on each company.

### **5. Due Diligence**

The Company then enters into a due diligence phase with The Keiretsu Forum members that signed the Interest List. The company sets a conference call or meeting at their office 7 to 10 days after the presentation. It is common for one or two members to take the lead in due diligence and negotiations with the company.

### **6. Multi-Chapter Investing**

After a company has presented to the chapter in the closest geography and has received investment interest traction from members of that chapter, the company then has the unique opportunity to present to other chapters of their choice. Members of each chapter conduct their own due diligence and make their own investment decisions; however they benefit greatly from shared due diligence.

In a large and well established region, typically 30 or more companies formally present, The Keiretsu Forum's Staff pre-screens a first level and members of Committees within specific industries review and pre-screen a sub-set of these, 7-10 companies present to members at a deal screening, 4-5 companies present at the Forums, and 2-3 companies move forward into Due Diligence. For Angel Capital Expositions, The Keiretsu Forum's staff with the support of some Committee members screen companies and there are no formal deal screening meetings.



# APPENDIX L - Standard Disclaimer for DD Team Members

The following sample disclaimer was written and provided by attorneys in law firms that are sponsors of The Keiretsu Forum Founding Region's chapters. The first section is oriented toward DD Leaders and DD Teams that author DD Reports for other members. The second section is also intended for inclusion in a DD Report, but is oriented toward the relationship between independent investors investing together, to address their relationship as actual co-investors in a company after a collaborative DD process. The attorneys who drafted these sections were considering the general requirements, and were not providing legal counsel to or with regard to any specific member, investor, or investment.

## **IMPORTANT DISCLAIMER & AGREEMENT (TERMS OF USE):**

Neither The Keiretsu Forum nor the individual members of the Due Diligence Committee that completed this Due Diligence Report (collectively, the "Keiretsu Parties") make any representations or warranties, either express or implied, with respect to the accompanying Due Diligence Report (the "Report"). The Keiretsu Parties disclaim all such representations, warranties and statements, express or implied, statutory or otherwise, including, without limitation, any implied warranties of merchantability, and fitness for a particular purpose or non-infringement. The accompanying Report represents solely the assessment of the authors and is provided on an "as is" basis and each recipient of the Report is encouraged to conduct your own, thorough due diligence, and work with their own attorneys, accountants and advisors with respect to any investment or other decision in connection with the investment opportunity that is related to or the subject of the Report. The Keiretsu Parties do not warrant or promise that the Report is correct, complete, omit to state any material fact or will be error free. In no event shall the Keiretsu Parties be liable to you or any third party for any indirect, special, consequential, or incidental damages, however caused, including, without limitation, damages for loss of principal, profits, revenue, data or use, incurred by you or any third party, whether in an action in contract or tort, incurred in connection with the Report, even if the Keiretsu Parties have been advised of the possibility of such damages.

Upon investing, each Purchaser acknowledges that it is not relying upon any person, firm or corporation, other than the Company and its officers and directors, in making its investment or decision to invest in the Company. Each Purchaser agrees that no Purchaser, nor the respective controlling persons, officers, directors, partners, agents or employees of any Purchaser, shall be liable to any other Purchaser for any action heretofore or hereafter taken or omitted to be taken by any of them in connection with the Purchased Shares.

# Appendix M - Additional Factors to Consider When Evaluating Companies in Specific Industries

Appendix F provides an outline for the content that should be covered in a typical, final Due Diligence Report. Appendix G provides a list of many of the items the author of a DD Report should be considering when writing the final Report, and potentially writing a synopsis of the DD Team's conclusions about a presenting company.

The sections of this Appendix cover factors that are unique to companies in various industries. The DD Leader, DD Team, and DD Report author should also consider these factors, if applicable, when conducting due diligence and writing the final Report.

The authors of the material below are identified at the top of each section.

Additional sections will be added to this Appendix in future, interim releases of the Handbook.

## Due Diligence Questions and Additional Due Diligence Factors and Processes When Evaluating Food and Beverage Companies

This section was written by Keiretsu Forum Founding Chapter member Phil Chernin, who has been a Keiretsu Forum member since 2001 and is Chairman of The Keiretsu Forum Founding Region's Food and Beverage Committee. Phil has 25 years of experience in the Specialty Foods and Consumer Products Industries. He can be reached at <http://www.cherninco.com>.

**Distributors:** How is the product distributed to customers? What agreements does the company have in place with Distributors? What geography does the distributor cover? Get examples of the stores the distributor serves. Note to DD team- distributors are key to the food distribution network. Acceptance of the product by a distributor is a vote of confidence as it means they are confident there are customers, confident the product fills a good niche, and confident in the product's quality.

**Distribution Channels:** There are many ways to get to the food retailer: be sure to understand the company's go to market strategy for each channel (C-store, small retailer, grocery, mass market, etc.). Note to DD team- It is common to distribute through multiple channels without losing focus.

**Brokers:** Does the company use brokers to sell their products? If so, who, what is their geographic coverage; does the broker have unique relationships with certain buyers? Note to DD team-Brokers are a good way to leverage the sales effort. Again, brokers add credibility to the products and company. They won't represent a company unless they feel there is good potential. Brokers can also serve as a good reference to verify the company's representations.

**Food Safety:** Does the company have a Food Safety and Sanitation plan? If they use co-packers, have they reviewed the plan of the co-packer? Visit the plant to ensure the plant is clean, and procedures are followed. Has the facility been audited by a Food Safety and Sanitation Company? Note to DD team- Food safety audits and ratings are essential; the larger retailers (Costco) will require this. The preparation for the audit is expensive, but it shows a commitment to food safety.

**Production and storage:** Does the company produce its own products or does it use a co-packer? Does product and do ingredients need special storage (frozen, refrigerated etc.), are ingredients readily available, is there price volatility for ingredients? Capacity-can they handle peak months, seasonality. What is shelf life and has it been verified by a lab? Is there a written product recall plan and has it been tested?

**Customers:** Pricing and terms. Seasonality. Any over dependence on one customer? How often do they re-order? Do any customers have unique requirements that disrupt production or distribution?

**Recipes:** Who owns the recipes? Do key employees have non-disclosure agreements in place? Are there non-compete agreements with co-packers?

**Sales and marketing:** What is unique about the product? How is the product positioned compared to others? What is the marketing message? Is the pricing competitive? How does the company handle different pricing across multiple channels (e.g. Costco will not charge the same price as Safeway)?

**Management Experience:** Note to DD team-there are too many pitfalls in the food production world to invest in a company without food experience. Dig deeply into this topic, although outside consultants and expertise is how most small companies cover their requirements.

Other topics to consider and questions to address:

1. How many product lines does the company have; have the company provide a list of them. How many products are in each line?
2. Why will stores take the company's products over existing, available products? Why?
3. Who are the company's largest competitors?
4. How does the company expect to grow?
5. What are the biggest constraints to growth?
6. How will the company fund its growth?

7. What is the company's gross profit percentage for wholesale, and distributor sales?
8. How do the executives describe and explain the company's marketing plan; have them provide a detailed summary.
9. Have the executives describe and explain the reasoning behind their choice for packaging. What is the company's approach to packaging?
10. If the retailers the company will distribute to charge for shelf space, will the company be able to afford those costs while it tests sell-through from distributors to end-customers?

# APPENDIX N - Procedures for Selecting and Maintaining A Keiretsu Forum Member Board Seat

As discussed in the section of this Handbook on Deal Closure (i.e. Stage 5), The Keiretsu Forum's members have had to adapt the process of selecting a Board member to represent Keiretsu Forum members in Keiretsu Forum portfolio companies. The Keiretsu Forum has grown from a single chapter with fewer than 100 members, most of whom had come to know each other personally, into a multi-chapter organization. Now, presenting companies that gain traction or receive significant investment in one Keiretsu Forum region often choose to present to other chapters.

This means several things. First, co-investors might not know, or even know of, each other. Second, new investors might invest after a Board Member has already either been selected or formally joined the portfolio company's Board. This might be the case as a bridge financing flows into a completed investment round or when a follow-on financing occurs. Third, new investors who invest very large amounts might feel strongly that they should represent Keiretsu Forum members on the Board. Fourth, new investors might have greater domain expertise, industry experience, or industry contacts and influence than the Keiretsu Forum member who had already joined the company's Board. And, fifth, there has come to be an increasing risk of inadvertently creating confusion for the leadership of portfolio companies that are interacting with the members of more than one Keiretsu Forum chapter.

...

The following procedures are meant to address these dynamics. Our shared objective should be to support our Portfolio Companies by providing as much expertise and as many resources as possible, with continuity and without creating any distractions to entrepreneurs that represent the interests of Keiretsu Forum members.

*The term "Keiretsu Board seat" and reference to "Keiretsu" in this Appendix refer to a member representing the members who invested in a company. He or she will not be representing The Keiretsu Forum itself.*

### General Overview - Timing

1. A Keiretsu Board seat should be in place until a follow-on financing leads to a restructuring of the company's Board (in order to balance representation with subsequent investors).
2. Who fills the Board seat may change as investors from other chapters invest (as outlined below). But, the Board seat will remain in place.
3. The initial Keiretsu Board member should be selected no later than the early part of stage 5. This is likely to occur between the formal hard circle and the transfer of funds.
4. This timing will assure that the Company has a chance to request that someone other than the first nominee represent Keiretsu on their company's Board.
5. Respect should be given to the company's concerns. But, ultimately, the most qualified person who can contribute the most should be placed on the Board.

### Optimal Selection Criteria

6. In making a selection, members are encouraged to weigh industry expertise, business experience relevant to the company's business model and industry, and contacts within the industry, as a higher priority than the amount of money each member is investing.

### Procedure - Formalities, No Plurality Necessary

7. The vote should be handled in writing, either by postings on the Gust Group or by email. This will create written documentation, thereby avoiding any confusion.
8. If members do not respond within one week of the DD Leader's communications about the vote, they shall be deemed to be abstaining. No plurality will be required. A majority shall be defined as a majority of the *voting members*.

### Inter-Chapter Financings - Who Votes

9. The reference to "voting members" may mean one of five things:
  - a. The total number of members within one chapter upon the first financing involving The Keiretsu Forum, if the company only presented in that location,
  - b. The total number of members within all chapters where the company presented, in the case of a first financing that includes members from multiple chapters,
  - c. The combined total number of members (be it in one chapter or multiple chapters) who already invested in a previous financing *and* who are investing in a subsequent financing, in the case of a follow-on financing, or,

- d. The combined total number of members (be it in one chapter or multiple chapters) who already invested *and* who are investing subsequently, in the case of an expansion of a financing round with an additional investment that involves no less than \$500,000, or,
- e. The combined total number of members (be it in one chapter or multiple chapters) who already invested *and* who are investing subsequently, in the case of a transition from a bridge financing using a convertible note to an equity financing that involves no less than \$500,000.

#### Inter-Chapter Financings - Who Manages The Voting Process

- 10. In a region with several formal chapters, the first chapter to invest refers to the first region to invest.
- 11. To select an initial Keiretsu Board member in an initial, multiple-chapter, first financing involving The Keiretsu Forum, the DD Leader from the chapter to which the company first presented will manage the voting process.
- 12. To select a potential replacement Keiretsu Board member in a subsequent, multiple-chapter financing, the DD Leader from the chapter to which the company first presented at the beginning of the new financing process will manage the voting process.
- 13. For this purpose, a subsequent financing should mean *both* a financing in which \$500,000 or more is invested *and* one in which the company is issuing a new class of shares (i.e. from series A to Series B). It should not mean a transition from a bridge or convertible note into the completion of the issuance of a class of shares.
- 14. If no member steps up to lead a formal DD process in the first chapter to which the company presented, then the first DD leader to step up from subsequent chapters to which the company presents should manage the voting process.
- 15. If no formal DD Process occurs, but Keiretsu members are able to secure a Board seat, the Keiretsu member investing the largest amount should either represent Keiretsu or ask an investor with the most experience in the relevant industry to represent Keiretsu.

#### Process For The Initial Selection (Upon The First Financing Involving The Keiretsu Forum)

- 16. After the hard-circle has been completed in stage 5 and the DD Leader knows which members will be investing, the DD Leader will find out which members want to serve on the company's Board.
- 17. If multiple chapters are investing concurrently, the DD Leader will communicate with the members of all of these chapters, and the process of selecting the Board representative will include a vote from new investors from all chapters.

18. However, if the current financing (be it a bridge financing or a full equity financing) will be completed while members of other chapters are just beginning to review the company and/or no members from other chapters will be investing, then the DD Leader will only communicate with members of the chapter or regions where the company initially presented. In this case, the procedures addressed below shall apply.
19. If one or more of the new investors wish to serve on the Board, then the DD Leader will conduct a vote from among the new investors. Whoever receives a majority vote from among the voting members will serve on the Board. If there are more than two candidates and nobody receives a majority, then the DD Leader shall conduct a second vote between the two top vote earners.

#### Alternative Board Member - Seeking Representation By Someone Who Did Not Invest

20. If all of the new investors (i.e. the members preparing to sign documents and transfer funds) decide that they prefer to ask another Keiretsu member with more industry experience who is not investing to represent them, the DD Leader will seek the assistance of the Keiretsu Team in finding an appropriate member.
21. The DD Leader will provide the bio of the person he or she finds to the new investors for consideration. If there is more than one alternative, then the new investors will vote from among the choices, with the person who receives the most votes becoming the Board member.
22. If there is disagreement among the new Keiretsu Forum investors as to whether the representative should be someone from among those who invested or someone who did not invest but has more industry expertise, then one of the actual investors should be chosen.
23. In this latter case, someone within the membership with significant expertise who might otherwise have been a candidate Board member should be made an advisor to the company. And, in addition to placing a Keiretsu member on the Board, placing this other member on the company's Board of Advisors (and providing him or her with the equity compensation that a Board of Advisors member would traditionally receive) should be made a pre-condition of the investment.

#### Approval by Company

24. The DD Leader will introduce the selected member to the company's founders. If the founders have a strong objection to working with the selected person, the DD Leader should request that the founders accept the runner-up. If neither is acceptable to the company, then accepting the winner of the vote should be made a pre-condition of the investment.



## Duration of Term and Replacement Board Member Selection

25. The Board member representing Keiretsu Forum members who invested in a portfolio company will serve on the Board until the earlier of the date of a follow-on financing or the point in time at which he or she no longer wishes to serve on the company's Board.
26. A follow-on financing may refer to one of two situations:
  - a. A financing that occurs after the previous round has been formally closed to all investors (not just Keiretsu Forum members), and the new investment is labeled by the company as a new issuance (i.e. from series A to series B), or
  - b. An equity financing that occurs after both a bridge round or financing involving a convertible note has been completed and, also, after a Keiretsu Forum investor has been both elected and formally installed on the company's Board.
27. An extension of an existing financing, regardless of its size, should not be considered a follow-on financing.
28. To maintain continuity between Keiretsu Forum members and the company, and to avoid potentially forcing the company to have to conduct a vote of the overall group of shareholders to approve a replacement Board member any more often than necessary, there should be a minimum term during which the Keiretsu Board representative shall serve.
29. If a follow-on financing occurs within less than one year of the date at which the Board member was both elected and formally placed on the company's Board, then the existing Board member should continue to serve until the end of that year.
30. In this situation, even if investors from a new chapter invest, it is expected that the initial Board member will continue to serve until the end of the one-year period.

## Vote Within a One Year Period

31. In some cases, an investor from a chapter whose members invest subsequently may wish to make his or her investment contingent upon becoming a Board member *after* a Keiretsu member has already been formally installed on the Board.
32. If the new investor will be investing less than \$250,000, then the existing Board member should remain on the Board until a follow-on financing occurs (as defined just above).
33. However, if this situation arises in the case of a multi-chapter, follow-on financing (as defined just above), then the vote should occur just prior to the close, but the change should not occur until the end of the one year period.
34. If the company prefers to have the new Board member begin serving immediately (such as if the company's leadership believes that the new member's presence on the Board

will help the company progress faster), then the existing Board member should respect this request.

35. The one year date shall be based on the date at which the company's shareholders approve the new Board member and he or she is formally installed on the Board ... not the point at which he or she was selected by the other new Keiretsu Forum investors.
36. It shall be understood that the transition shall not take place until after one year from the date that the initial Board representative was formally approved as a Board member by the Company's shareholders. The new investor should not apply any pressure on the company to make the change sooner. In practice, the time-gap will usually be short.
37. The intention behind conducting the vote but delaying the transition is to create clarity for new potential investors without forcing the company to have to deal with the logistics of a vote among existing shareholders within any less than a one year period.

#### Recommendation To The Company

38. The DD Leader should suggest that the company's attorneys evaluate and use a method, if possible, of creating a generic Board seat for Keiretsu that will enable the person filling that Board seat to be change subject only to approval by the existing Board, without requiring the approval of shareholders.

## APPENDIX O - Gust Overview

The following two overviews have been provided by Gust and created by The Keiretsu Forum as tools to orient investors on how to use the Gust platform.



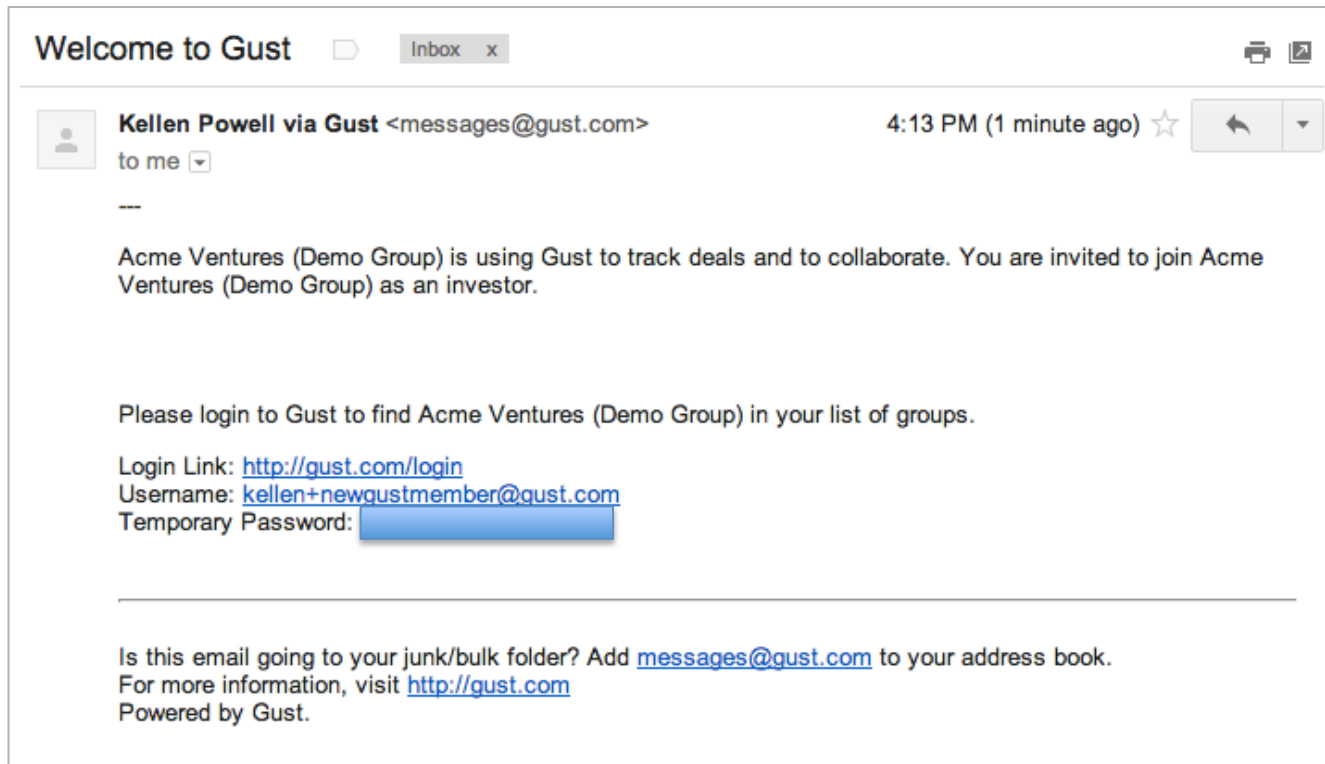
**gust**  
*venture forward*

**Investor Guidebook**

# Gust: Getting Started

When you are first added to a group that uses Gust, you will receive a welcome email from the group.

If you do not already have a Gust account with another group, Gust will include your new login credentials in the email.



The screenshot shows an email interface with the following content:

**Welcome to Gust** Inbox x Print Share

**Kellen Powell via Gust** <messages@gust.com> 4:13 PM (1 minute ago) Star Reply Dropdown

to me ▾

---

Acme Ventures (Demo Group) is using Gust to track deals and to collaborate. You are invited to join Acme Ventures (Demo Group) as an investor.

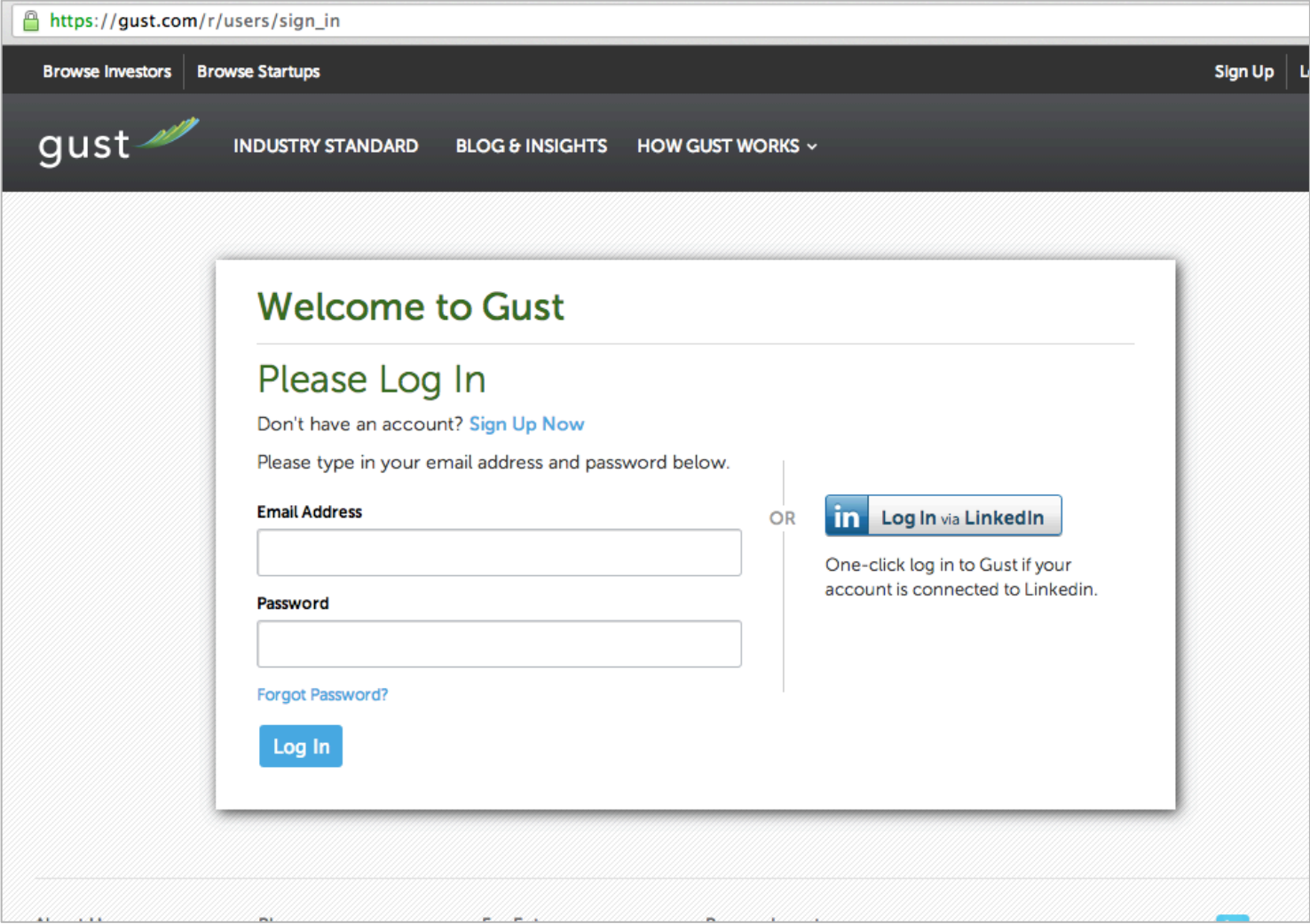
Please login to Gust to find Acme Ventures (Demo Group) in your list of groups.

Login Link: <http://gust.com/login>  
Username: [kellen+newgustmember@gust.com](mailto:kellen+newgustmember@gust.com)  
Temporary Password: [REDACTED]

---

Is this email going to your junk/bulk folder? Add [messages@gust.com](mailto:messages@gust.com) to your address book.  
For more information, visit <http://gust.com>  
Powered by Gust.

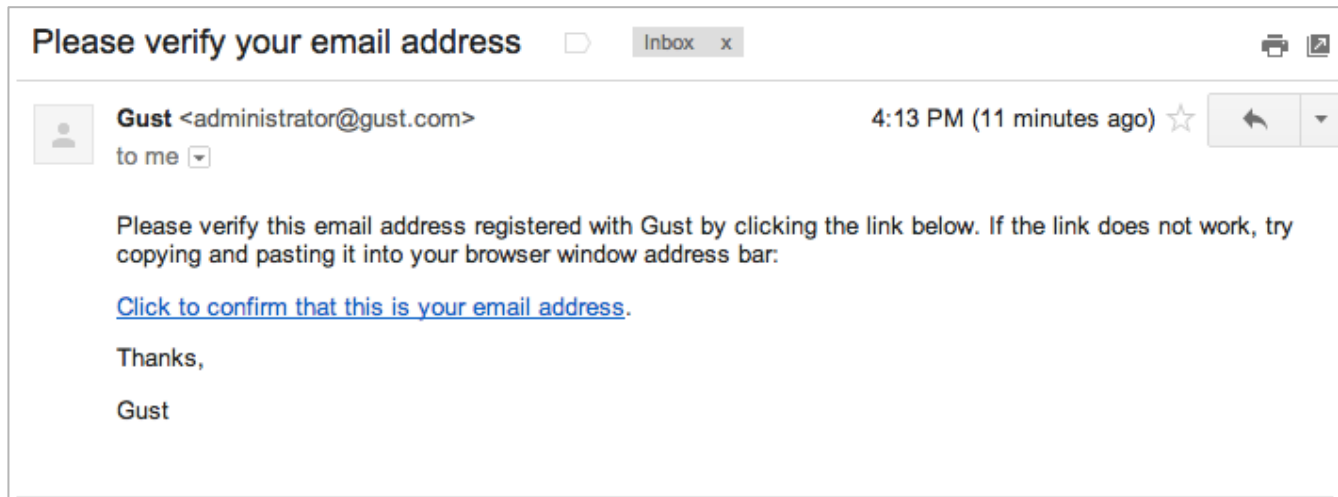
# Gust: Logging In



The screenshot shows the Gust website's login page. At the top, there is a navigation bar with links for "Browse Investors", "Browse Startups", "Sign Up", and "Log In". The Gust logo is on the left, and navigation links for "INDUSTRY STANDARD", "BLOG & INSIGHTS", and "HOW GUST WORKS" are on the right. The main content area is a white box with a light gray background pattern. It features the heading "Welcome to Gust" and "Please Log In". Below this, there is a link for "Sign Up Now" for users without an account. The login form includes fields for "Email Address" and "Password", a "Log In" button, and a "Forgot Password?" link. To the right of the form, there is an "OR" separator and a "Log In via LinkedIn" button. Below the LinkedIn button, it says "One-click log in to Gust if your account is connected to LinkedIn."

Enter your user name and password.

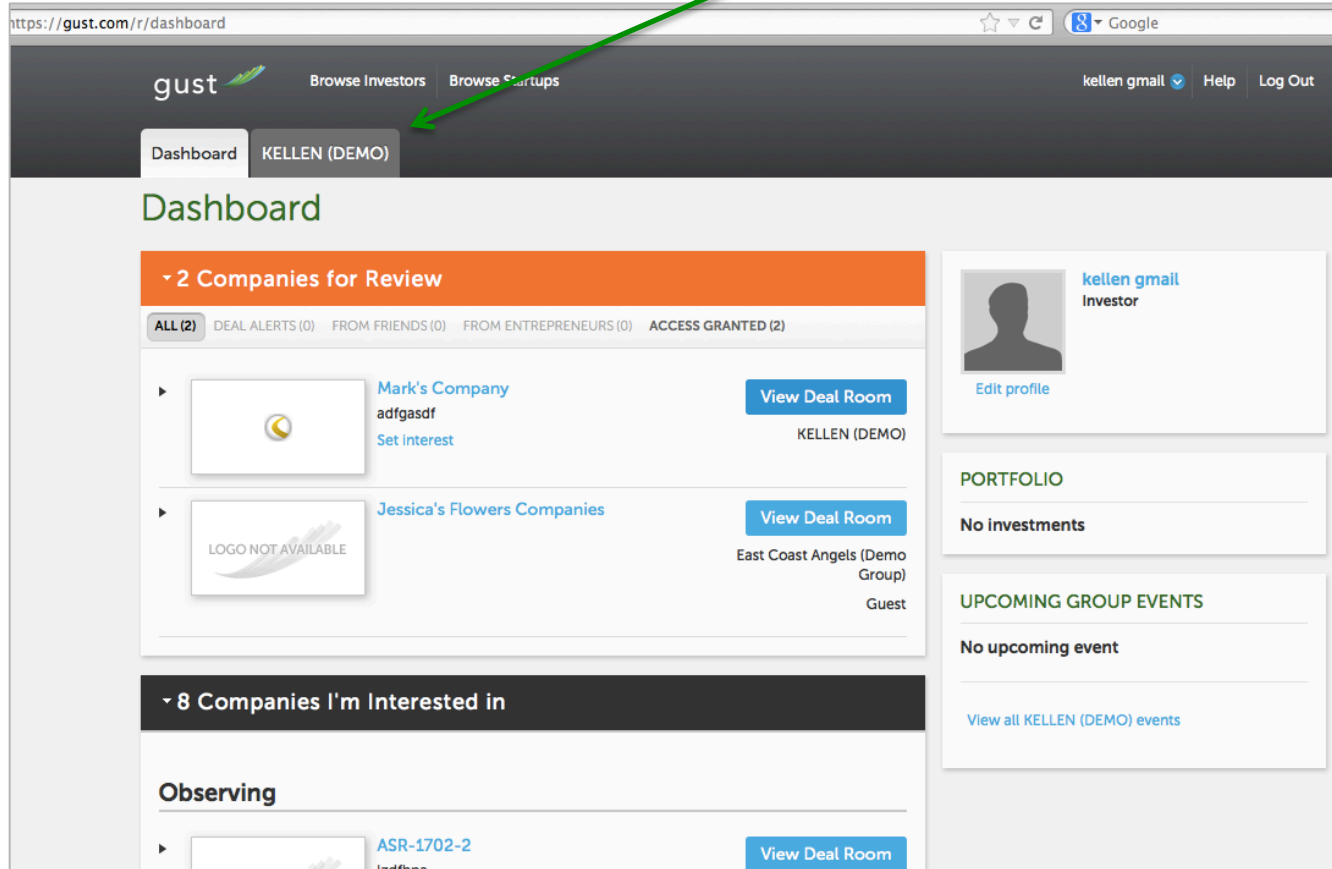
# Gust: Confirming Your Email Address



If you are new to Gust, you will also receive an email asking you to confirm your email address. You can do so from the link here, in the email.

# Gust: Dashboard

Upon logging in to Gust, you will see a series of tabs, representing each of the groups that includes you as a registered user.



To begin using Gust, click on the tab with the name of your desired group, and leave the Dashboard.

(The Dashboard will be covered in a later section of this document.)



# Gust: Deal List

The screenshot shows the Gust Deal List interface. At the top, there's a navigation bar with the Gust logo, "Browse Investors", "Browse Startups", and user options "kellen gmail", "Help", and "Log Out". Below this is a sub-header "KELLEN (DEMO)" with tabs for "Dashboard" and "KELLEN (DEMO)". A secondary navigation bar includes "DEAL LIST", "EVENTS", "GROUP MESSAGES", "DOCUMENTS", and "SUBGROUPS".

Below the navigation is a search bar with "Enter keyword" and a "SEARCH" button, along with "NEW DEAL" and "PRINT" buttons. The main content area is titled "Deal Stage" and "New (1-50 of 59)". It features a table with columns: Deal, Stage, Rating, Source, Created By, Industry, Created, and Entrepreneur. The table lists various deals such as "Urban Grocery Recycling", "kellen", "braveheart", "Fukushi", "Apartment Hunters", "MASKCo (Withdrawn)", "TESTINVITATION", "1234 (Withdrawn) (Video)", "caps lock test", "capslock", and "Disclaimer Test 2".

On the left side, there are filters for "Deal Stage" (View All (73), New (59), In Progress (6), Invested (0), Inactive (4)) and "Deal Labels" (Label (3)).

Four blue stars are overlaid on the image to highlight key search and filter elements: one on the "SEARCH" button, one on the "Deal Stage" filter section, one on the "Deal Labels" filter section, and one on the "Deal" column header of the table.

The Deal List shows all the deals you may access in the group. There are four main ways to search for deals.

1. By name in the search bar;
2. By stage in the deal stages section;
3. By label in the deal labels sections (Set by Group Administrators), and
4. By arranging deals by the column listings.

# Gust: Deal Rooms

The screenshot shows the Gust Deal Room interface for 'Urban Grocery Recycling'. At the top, there's a navigation bar with 'Dashboard' and 'KELLEN (DEMO)'. Below that, the deal title 'Urban Grocery Recycling' is displayed, along with 'Your Interest: Observing' and 'Your Rating: Not Rated'. A navigation menu includes 'DEAL HOME', 'MESSAGES', 'DOCUMENTS', and 'HISTORY'. Action buttons for 'SET INTEREST', 'RATE & REVIEW', 'CREATE MESSAGE', and 'REQUEST TO BE DEAL LEAD' are visible, along with the 'Deal Stage: New' indicator. A notification bar states 'No new updates'. The main content area features a company logo, a brief description, and a 'CONTACT' section with fields for name, email, location, industry, founded date, and employees. A 'COMPANY PROFILE' section is also present. Below this, there are four thumbnails for 'Company Profile', 'Business Summary', 'Financial Info', and 'Documents'. A warning message indicates that entrepreneurs do not have access to this area. The bottom section is titled 'Collaborate on this Deal' and shows 'Deal Interest' accessible to 35 members, with a table listing the lead group (KELLEN (DEMO)), deal lead (Kellen Powell), and observing members (kellen@gmail.com). There are also sections for 'Investment Group Notes' and 'Upcoming Events', both of which are currently empty.

Dashboard | KELLEN (DEMO)


## Urban Grocery Recycling

Your Interest: Observing  
Your Rating: Not Rated

DEAL HOME | MESSAGES | DOCUMENTS | HISTORY

SET INTEREST | RATE & REVIEW | CREATE MESSAGE | REQUEST TO BE DEAL LEAD | Deal Stage: New

No new updates - VIEW ALL

 **Urban Grocery Recycling** [PRINT](#)

We pick up spoiled or unwanted food from your home and turn it into fuel for vehicles.

**CONTACT**

NAME	Gust Entrepreneur ✓
EMAIL	kellen+ugrgustentr...

**COMPANY PROFILE**

LOCATION	Brooklyn, NY, US
INDUSTRY	Consumer Products and Services
FOUNDED	Apr-02-1985
EMPLOYEES	8

CREATED ON JUN 20, 2013 BY KELLEN POWELL  
UPDATED ON JUN 20, 2013 BY GUST ENTREPRENEUR

View Entrepreneur's Investor Relations Site  
[what's this?](#)

Company Profile | Business Summary | Financial Info | Documents

Entrepreneurs do not have access to this area. [Learn More](#)

### Collaborate on this Deal

Deal Interest Accessible to 35 members and guests [Set Your Interest](#) | [Request to be Deal Lead](#)

LEAD GROUP	KELLEN (DEMO)
DEAL LEAD(S)	Kellen Powell
OBSERVING	kellen@gmail

**Investment Group Notes**  
There are no Group Notes.

**Upcoming Events**  
There are no Events.

The Deal Room serves 2 main functions:

1. allowing investors to view the materials of an entrepreneur's Startup Profile, and
2. allowing investors to collaborate by sending messages, setting ratings and leaving reviews, and sharing documents.

# Gust: Deal Rooms

The entrepreneur's Start Up Profile is broken into sections. You can click on a section of the profile to view it.

The profile sections are:

- Company Profile
- Business Summary
- Financial Information
- Pitch
- Documents
- Supplemental Materials

The screenshot shows a web browser window displaying a deal room profile on Gust.com. The URL is [https://gust.com/deal/kellen\\_demo\\*urban.grocery.recycling\\*kellen\\_demo/](https://gust.com/deal/kellen_demo*urban.grocery.recycling*kellen_demo/). The profile information includes:

NAME	Gust Entrepreneur ✓	LOCATION	Brooklyn, NY, US
EMAIL	kellen+ugrustentr...	INDUSTRY	Consumer Products and Services
		FOUNDED	Apr-02-1985
		EMPLOYEES	8

CREATED ON JUN 20, 2013 BY KELLEN POWELL  
UPDATED ON JUN 20, 2013 BY GUST ENTREPRENEUR

View Entrepreneur's Investor Relations Site  
[what's this?](#)

Company Profile Business Summary Financial Info Documents

Entrepreneurs do not have access to this area. [Learn More](#)

### Collaborate on this Deal

Deal Interest *Accessible to 35 members and guests* [Set Your Interest](#) | [Request to be Deal Lead](#)

LEAD GROUP	KELLEN (DEMO)
DEAL LEAD(S)	Kellen Powell
OBSERVING	kellen gmail Kellen Powell

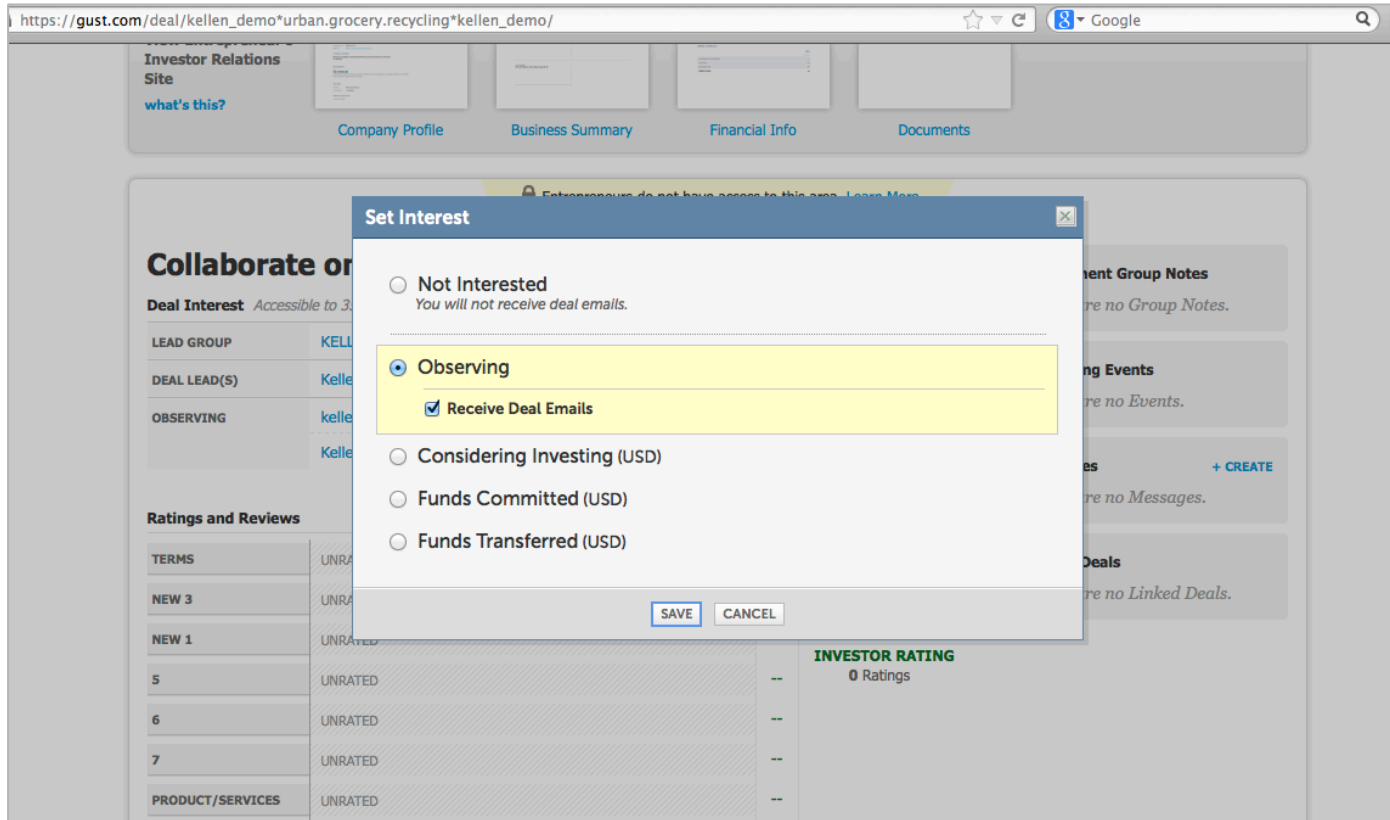
Investment Group Notes  
*There are no Group Notes.*

Upcoming Events  
*There are no Events.*

Messages [+ CREATE](#)

A green arrow points from the text on the right to the 'Company Profile' section in the screenshot.

# Gust: Deal Rooms



Clicking “Set Your Interest” in a deal room will prompt you to state an interest level in the deal. If you don’t wish to participate you should choose “Not interested.”

# Gust: Deal Rooms

**Ratings and Reviews** [Rate & Review](#) · [Customize](#)

TERMS		2.3
YES NO OR MAYBE		2.7
YES OR NO		2.0
MANAGEMENT TEAM		1.6
FUTURE PLANS		1.7

**68%**  
INVESTOR RATING  
3 Ratings

**Benjamin WATTINNE** 12/20/12 · [DELETE](#)  
Interesting but we need to better investigate the competitors, they are a lot!

TERMS: **2 / 3**    YES OR NO: **2 / 3**    FUTURE PLANS: **1 / 3**  
YES NO OR MAYBE: **3 / 3**    MANAGEMENT TEAM: **2 / 3**

**67%**  
rated across 5/5 categories

**Steve Wood** 10/18/12 · [DELETE](#)  
mgt team I have questions

TERMS: **2 / 3**    YES OR NO: **2 / 3**    FUTURE PLANS: **2 / 3**  
YES NO OR MAYBE: **2 / 3**    MANAGEMENT TEAM: **1 / 3**

**72%**  
rated across 5/5 categories

**Justin Stanwix** 3/4/12 · [DELETE](#)  
There is huge potential here but only if they are receptive to coaching.

TERMS: **2 / 3**    YES OR NO: **2 / 3**    FUTURE PLANS: **2 / 3**  
YES NO OR MAYBE: —    MANAGEMENT TEAM: —

**63%**  
rated across 3/5 categories

**Add your review** (Rate this deal - 1 is the lowest)

TERMS	<input type="text" value="Please Rate"/>	MANAGEMENT TEAM	<input type="text" value="Please Rate"/>
YES NO OR MAYBE	<input type="text" value="Please Rate"/>	FUTURE PLANS	<input type="text" value="Please Rate"/>
YES OR NO	<input type="text" value="Please Rate"/>		

Please type your review here.

[Save](#) [Cancel](#) *This review will not be shared with the entrepreneur.*

You can also set a numerical rating and write a review of the company's profile.

# Gust: Deal Rooms

The screenshot shows the Gust Deal Room interface for a deal titled "Urban Grocery Recycling". At the top, there are navigation tabs for "Dashboard" and "KELLEN (DEMO)". Below this, the deal title "Urban Grocery Recycling" is displayed, along with a box indicating "Your Interest: Observing" and "Your Rating: Not Rated". A secondary navigation bar includes "DEAL HOME", "MESSAGES", "DOCUMENTS" (which is the active tab), and "HISTORY". Below the navigation, there are buttons for "MOVE ITEMS", "NEW FOLDER", and "DOWNLOAD". The main section is titled "All Documents" and contains the text: "Add documents here that you want to share with all deal members. Attachments to emails sent to the deal email address will automatically be stored here." A note below states "Note: File size limit is 75MB." There is an "Upload Document" button with a plus icon. Below this is a table listing documents:

<input type="checkbox"/>	Document Name	Size	Uploaded by	Times Downloaded	Date	Quick Link
<input type="checkbox"/>	<a href="#">Entrepreneur Documents</a>	1 item	Gust Entrepreneur	--	6/20/13	

Documents from the entrepreneur's Startup Profile also end up in the Entrepreneur Documents folder in the Documents tab at the top of the deal room. They can be downloaded in either place.


Documents uploaded by other members of the group will also be accessible from the documents tab.

\*The entrepreneur does not have visibility into this tab, even though documents from their site are pulled into it when they submit.

# Gust: Deal Rooms

SET INTEREST RATE & REVIEW CREATE MESSAGE REQUEST TO BE DEAL LEAD Deal Stage: New


No new updates · [VIEW ALL](#)



## Urban Grocery Recycling

[PRINT](#)

**DOCUMENT QUICKLINKS**

 [urban.grocery.recycling-application.pdf](#)

[VIEW ALL](#)

We pick up spoiled or unwanted food from your home and turn it into fuel for vehicles.

CONTACT		COMPANY PROFILE	
NAME	Gust Entrepreneur ✓ <a href="#">kellen+ugrgustentr...</a>	LOCATION	Brooklyn, NY, US
EMAIL		INDUSTRY	Consumer Products and Services
		FOUNDED	Apr-02-1985
		EMPLOYEES	8

CREATED ON JUN 20, 2013 BY KELLEN POWELL ·  
UPDATED ON JUN 20, 2013 BY GUST ENTREPRENEUR

Documents can also appear on the main page of the Deal Home under "Quicklinks."

Recent versions of the printable PDF version of an entrepreneurs profile, and other important documents marked by your group and deal administrators will appear here.

# Gust: Dashboard

Deals are arranged in the Dashboard according to interest level. These deals may include those you have evaluated or are following, those deals affiliated with your groups, or deals you have individually sourced through the startup search engine.

Dashboard KELLEN (DEMO)

## Dashboard

2 Companies for Review

ALL (2) DEAL ALERTS (0) FROM FRIENDS (0) FROM ENTREPRENEURS (0) ACCESS GRANTED (2)

Mark's Company  
adfgasdf  
Set interest  
View Deal Room  
KELLEN (DEMO)

Jessica's Flowers Companies  
LOGO NOT AVAILABLE  
View Deal Room  
East Coast Angels (Demo Group)  
Guest

8 Companies I'm Interested in

### Observing

ASR-1702-2  
lzdfbna  
Set interest  
View Deal Room  
KELLEN (DEMO)

kellen gmail  
Investor  
Edit profile

PORTFOLIO  
No investments

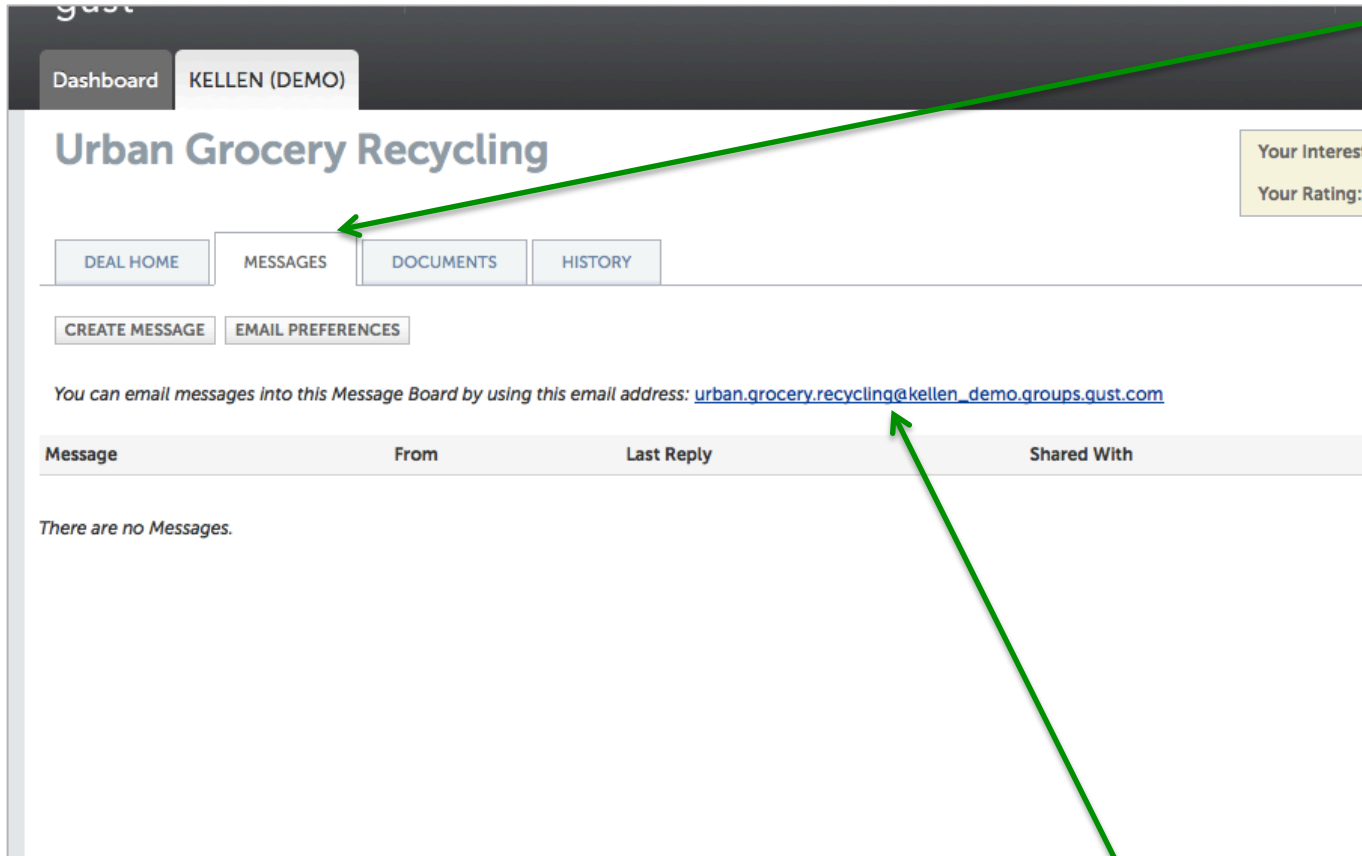
UPCOMING GROUP EVENTS  
No upcoming event  
View all KELLEN (DEMO) events

If you have indicated "Funds Transferred" for any deals, the companies will appear in the Portfolio.

Events from any of your groups will be organized here. Clicking on an event will take you to the event page with more detailed info and an RSVP feature.



# Gust: Deal Rooms



You can create a forum-style message here.

The message will be available to anyone with access to the deal room (not necessarily entrepreneurs, as entrepreneurs don't see the deal room). If individuals are subscribed to receive deal messages, they receive e-mail copies of the message as well.

You can also use this e-mail address to mail in a message. It will generate a post here in the messages forum and be sent to subscribed members.

# Gust: Deal Rooms

Uncheck "Subscribed Investors" if you don't want an e-mail copy to be sent.

Dashboard KELLEN (DEMO)

Urban Grocery Recycling

Your Interest: Observing  
Your Rating: Not Rated

DEAL HOME MESSAGE

CREATE MESSAGE EMAIL PRE

You can email messages into th

Message

There are no Messages.

**Create Message**

To:  Message board for "Urban Grocery Recycling" Deal Room  
 Subscribed Investors  
Maia Engell, kellen gmail, Dave Jones, Kellen Powell

Entrepreneur (replies will also be sent to entrepreneur)

Subject:

Message:

[+ Add Attachment](#)

Options:  Email replies only to me

SEND CANCEL

If you wish to send a copy of the message to the entrepreneur, check this box. The entrepreneur will receive an e-mail copy only; he/she can't see the message forum.

When you check the option "Email replies only to me," users that respond to your messages via e-mail will be e-mailing directly to your e-mail inbox, bypassing the message forum. The default for this is to be checked, so if you want replies to be shared with everyone, remember to uncheck it when you send a message.

Additional questions? Need more training?  
e-mail [support@gust.com](mailto:support@gust.com) or call 1.866.839.7530

**“Great Association with Quality Deal Flow”**

KEIRETSU



FORUM

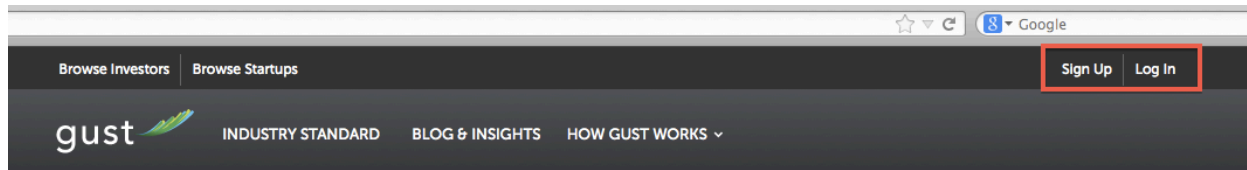
# Gust Manual

[www.keiretsuforum.com](http://www.keiretsuforum.com)

# How to log in

## Option 1

1) Open your web browser and type [www.gust.com](http://www.gust.com)



## The Global Platform for Startup Funding

Over 1,800 startups funded in the last 12 months

Get Started

2) Click on “Log in”, indicated by the red mark



3) Enter your credentials provided by Keiretsu Forum

4) Click “Log In”

## Option 2

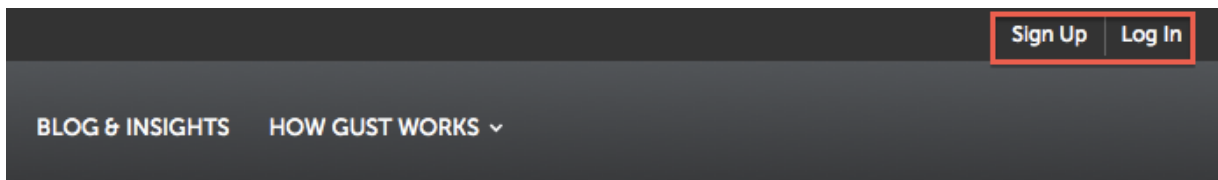
1. Go to keiretsuforum.com and click on “Member Login”



2. From the list find your region or chapter and click on “LOGIN”

REGION	CONTACT	MEMBER LOGIN	BECOME A MEMBER
US: Northern California	Sonja Markova	<b>LOGIN</b>	<b>JOIN</b>
US: Northwest	Nathan McDonald	<b>LOGIN</b>	<b>JOIN</b>

3. Click on “Log In” from the resulting Gust screen



4. Enter your credentials provided by Keiretsu Forum and click “Log In”

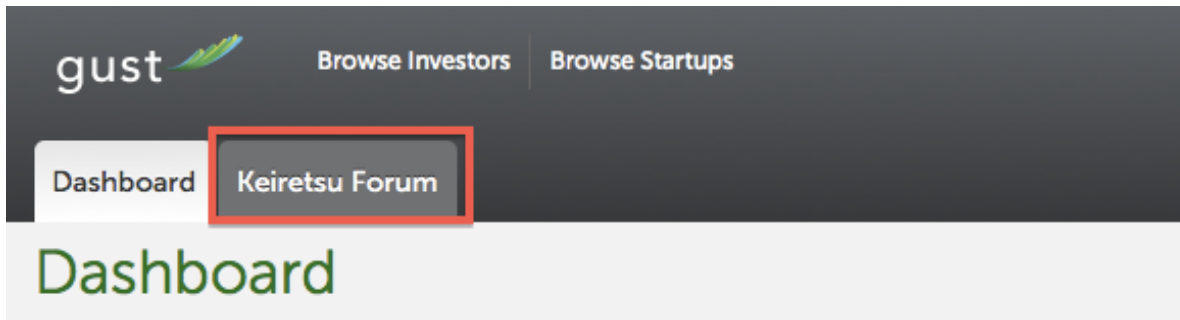
**Email Address**

**Password**

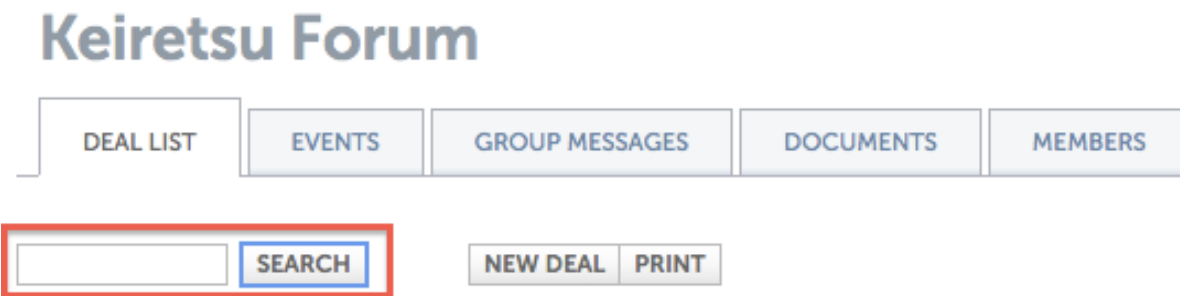
[Forgot Password?](#)

**Log In**

## How to get detailed information on a company



1. After you are logged in, click on “Keiretsu Forum” on the Navigation Bar



2. Type the company name in the Search bar and click “Search”

The screenshot shows the search results for 'Telnexus' in the Keiretsu Forum. The search bar contains 'Telnexus' and the 'SEARCH' button is highlighted. The results are displayed in a table with columns for 'Deal Stage' and 'Deal'. The 'Deal Stage' column shows 'New (1)', 'In Progress (156)', 'Invested (28)', 'Inactive (628)', and 'Shared Deals'. The 'Deal' column shows 'New (1-1 of 1)' and 'Telnetus LLC'. The detailed profile for Telnexus LLC is shown on the right side of the screen.

Deal Stage	Deal
<a href="#">View All (813)</a>	
<b>New (1)</b>	<a href="#">Telnetus LLC</a>
▶ <a href="#">In Progress (156)</a>	<a href="#">EUREKA! Candidate</a>
▼ <a href="#">Invested (28)</a>	
2012 (9)	
2011 (2)	
▶ <a href="#">Inactive (628)</a>	
<b>Shared Deals</b>	
▶ <a href="#">Referred Out (35)</a>	
▶ <a href="#">Referred In (14)</a>	
Co-invested In (0)	
▶ <a href="#">Co-invested Out (1)</a>	

### Telnexus LLC

Telnexus is a startup telecom carrier based in Berkeley, CA selling VoIP subscriptions and performing complex installations

<b>Created By:</b> Vernon Keenan	<b>Company Profile:</b> Industry: Telecommunications Employees: 7 Founded: Jul-29-2012
<b>Contact Information:</b> Vernon Keenan ✓ vern@telnexus.com 2020 Milvia Street Suite 250 Berkeley, CA 94704 US http://www.telnexus.com	<b>Financial Information:</b> Company Stage: Full Product Ready Capital Raised: \$50,000 Pre-money Valuation: \$650,000 Monthly Net Burn: \$15,000 Capital Seeking: \$350,000
<b>Management:</b> Eugene Evans, Chief Engineer Nat Goldhaber, Chairman Vernon Keenan, CEO	

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**Your Interest:** Not Set  
**Your Rating:** Not Rated

3. Find the company from the results. Hover on the link to see a snapshot of company details. Click on the company name to enter the deal room for more detailed information such as financial statements.

### How to write a review and rate the companies

1. After you click on the company name under Keiretsu Forum tab to access detailed information you can set your interest level, rate or review the company or create messages for other Keiretsu Forum members to see.

**Telnexus LLC**

**EUREKA! Candidate**

Your Interest: Not Set  
Your Rating: Not Rated

DEAL HOME | MESSAGES | DOCUMENTS | HISTORY

SET INTEREST | RATE & REVIEW | CREATE MESSAGE | REQUEST TO BE DEAL LEAD

Deal Stage: New

No new updates · VIEW ALL

**Telnexus** PRINT

**Telnexus LLC**

*Telnexus is a startup telecom carrier based in Berkeley, CA selling VoIP subscriptions and performing complex installations*

DOCUMENT QUICKLINKS

telnexus.llc-application.pdf

VIEW ALL

2. From this page click “Rate&Review” or scroll down to see the review toolbox. Here you can rate the company’s management team, terms, product/service and market.

**Add your review** (Rate this deal - 1 is the lowest)

MANAGEMENT TEAM Please Rate

PRODUCT/SERVICES Please Rate

TERMS Please Rate

MARKET Please Rate

Please type your review here.

Save Cancel

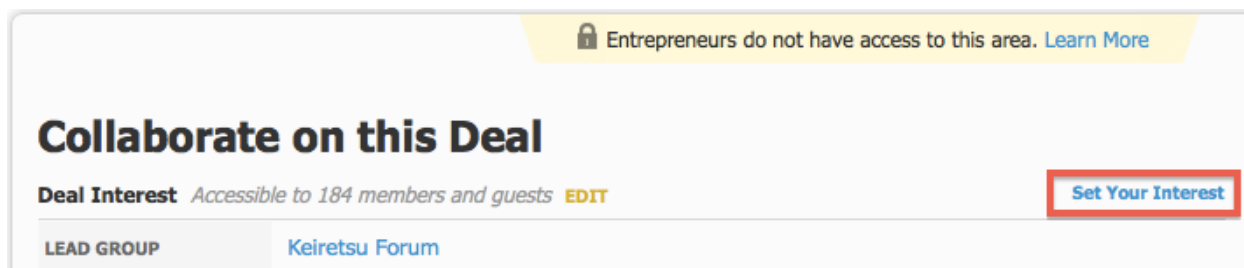
*This review will not be shared with the entrepreneur.*



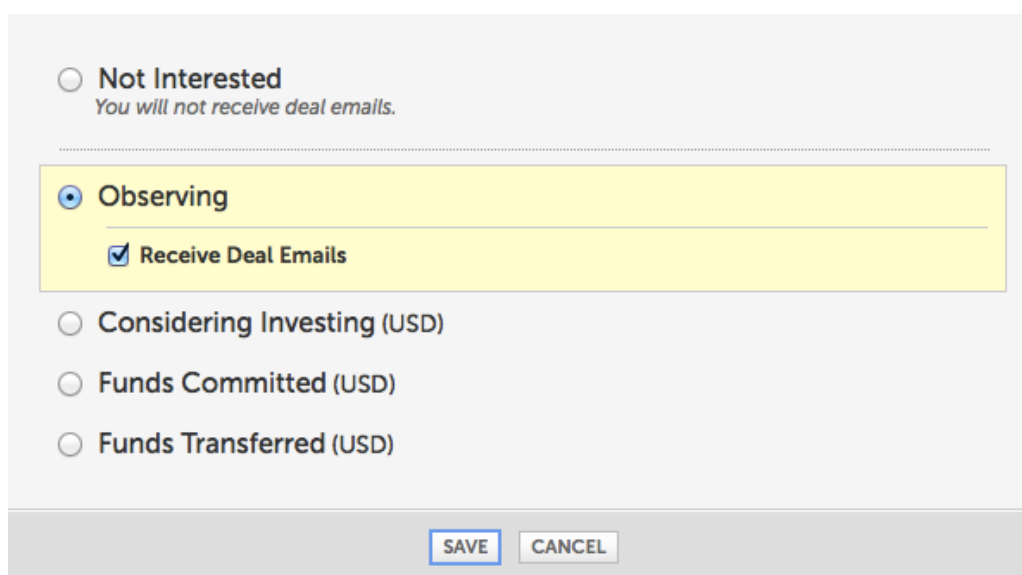
3. You can also add your review to the company for other Keiretsu Forum members to see. Your review will not be shared with the entrepreneur.

### Changing your interest level on a company

After you find the company and clicked on its name, you will be in the “deal room”. Here you can set your interest level on a company as well as see other interested members.



Click on the “Set Your Interest” link indicated by the red mark.



Select your level and click on “Save” to set your interest level. Other members are able to see your interest levels.

## General Navigation

When you log in, you can navigate around Gust by the upper two tabs. Under “Dashboard”, you can see the companies you are interested in and companies that are available for you to review.

Under “Keiretsu Forum” tab, you can find the Keiretsu Forum Deal List. They are organized by the current stage they are in. You can navigate by the side bar.

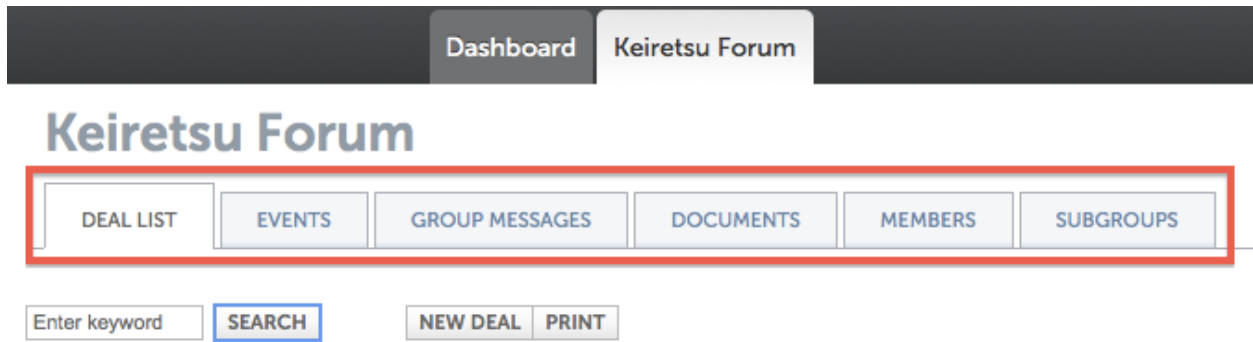
The screenshot shows the Gust Keiretsu Forum interface. At the top, there is a navigation bar with the Gust logo and links for "Browse Investors" and "Browse Startups". Below this, two tabs are visible: "Dashboard" and "Keiretsu Forum", with a red box highlighting both. The "Keiretsu Forum" page has a sub-navigation bar with "DEAL LIST", "EVENTS", "GROUP MESSAGES", "DOCUMENTS", "MEMBERS", and "SUBGROUPS". Below this is a search bar and "NEW DEAL" and "PRINT" buttons. The main content area shows a table of deals with columns for Deal Stage, Deal, Stage, Rating, Created By, and Industry. A sidebar on the left lists deal stages like "New (5)", "In Progress (165)", etc.

Upper tabs are indicated by the red mark, click to navigate

The screenshot shows the Gust Keiretsu Forum interface, similar to the previous one, but with a red box highlighting the sidebar on the left. The sidebar lists deal stages such as "View All (835)", "New (5)", "In Progress (165)", "Sent Process - Regular (38)", "Sent Process - Seed (78)", "Committee Review (4)", "Invite to Deal Screening (1)", "Invite to Monthly Forum (0)", "In Due Diligence (34)", "Invested (28)", "Inactive (637)", "Shared Deals", "Referred Out (36)", "Referred In (15)", "Co-Invested In (0)", and "Co-Invested Out (1)". The main table of deals is also visible.

Side bar is indicated by the red mark, click the links to navigate

Under Keiretsu Forum tab, you can access these areas: Deal List, Keiretsu Forum Events, Group Messages, Keiretsu Forum Documents, Member List and Subgroups



Tabs are indicated by the red mark, click on them to navigate

### Adding Information to Your Profile

To add information to you profile on Gust, click on your name on the upper-right corner.



After you click on your name, in the following page you can click on the blue “Edit” link in any field to add information to that field. After you are done, click on “Save” button to save your update.

### Experience

#### Biography

5500 characters remaining

#### Position History

[Add a position](#)

# APPENDIX P – Common Deal Terms, Definitions, and Illustrative Text

## Keiretsu Forum Overview Of Common Venture Financing Term Sheet

Provided by Keiretsu Forum Sponsor Reed Smith  
(Not Intended To Be a Substitute for Legal Counsel)

This Summary is intended to provide an overview of key terms in venture financing terms that investors should consider when reviewing or drafting financing term sheets.

Each section of the Overview covers one category of key Term Sheet provisions, and discusses the following:

**Definition:** A brief definition of the term sheet provision and the typical “terms of art” used in term sheets.

**Variations:** A summary of the key variables and the range of “market terms” for each of the term sheet categories.

**“When Important”:** A brief discussion of how to assess the importance of the provision in the context of a particular deal.

**Sample Language:** Typical sample language from a financing term sheet covering the relevant provision.

We hope this summary provides a useful starting point for investors in considering investment term sheets. While the summary covers a majority of the categories that are likely to be relevant in a typical early-stage financing, each transaction involves unique considerations and may involve key issues not addressed in this summary.

For any questions or suggestions, please contact Ramsey Hanna (rhanna@reedsmith.com) or Don Reinke (dreinke@reedsmith.com).

### Pre-/Post-Financing Valuation

**Definition:**

- “Pre-Financing” or “Pre-Money” valuation refers to the value of the Company before taking into account the cash contributed in the financing. The Pre-Money Valuation is simply the product of the *price per share* paid by investors in the financing and the *number of shares in the Company’s capitalization* before the financing.
- “Post-Financing” or “Post-Money” Valuation refers to the Company’s value after including the funding proceeds. It is simply the sum of the Pre-Financing Valuation and expected proceeds from the financing.

**Variations:** Since the Company valuation is the product of price per share and Company capitalization, valuation numbers mean different things depending on how the Company defines its capitalization.

- **Shares Outstanding:** This is the narrowest definition of capitalization, and refers only to the shares of Common Stock and/or Preferred Stock of the Company that are issued and outstanding prior to the financing. It does not include shares issuable upon exercise of outstanding options, warrants and convertible securities.
- **“As-converted” Capitalization:** The “as-converted” capitalization of a Company is an expanded definition of capitalization that includes both shares that are actually issued and outstanding, and all shares that would be issued if all options and warrants outstanding are exercised in full and all convertible securities outstanding (e.g. convertible promissory notes) are converted into equity.
- **Fully diluted capitalization:** The “fully diluted” capitalization of a Company is the most expansive view of its capitalization. It includes, in addition to the Company’s “as-converted” capitalization, shares reserved for issuance under any stock option plans or other equity incentive plans maintained by the Company. Investors will often require that the Company’s equity incentive plans include a reserve sufficient to cover the Company projected equity incentive awards for the next 12-24 months, which for early stage companies often translates into 10-25% of the Company’s outstanding shares.

The most expansive definition of capitalization is most favorable to investors, since it results in the lowest price per share for any given valuation level. VC investors typically base valuation discussions on a fully diluted definition of Company capitalization.

**When Important:** Always. Understanding the capitalization definition used by the Company is critical in evaluating a proposed Company valuation. A \$5 “fully diluted” valuation may be entirely reasonable, while a \$5 million “shares outstanding” valuation may not: The investors’ expected return on investment is a direct function of the Company’s pre-money valuation.

**Sample Language:** “Purchase price will be \$1.00 per share of Series A Preferred Stock, based on [an as-converted/a fully-diluted] pre-financing valuation of the Company of \$5 million.”

## **Type of Security: Preferred vs. Common vs. Convertible Notes**

**Definition:** The term sheet will define the type of security investors will receive for their investment. The type of security issued will to a great extent shape the structure and economics of the transaction.

**Variations:** Early stage investments almost always involve one of the following three types of securities:

- **Preferred Stock:** Preferred Stock financings are the predominant structure for investments by Keiretsu Forum members and other angel investor groups. Preferred stock is a senior class of equity security that will have a number of preferential rights and preferences, relative to the holders of the Common Stock class (which will include the company’s founders and employees). Over time, the company may issue multiple classes of Preferred Stock, typically designated sequentially as Series A, Series B etc. Preferred Stock. Since it is the predominant structure, much of this Overview addresses common terms of Preferred Stock financings.

- **Common Stock:** Occasionally, angel investments are structured as Common Stock financings - meaning that investors receive the same class of Common equity as that held by the company’s founders and employees. If this is the case, then many of the special rights described in this Overview - including liquidation preferences, anti-dilution rights and special voting rights - will not be available to investors. A Common Stock structure may be justified in the case of a very early-stage (“seed stage”) financing at a low valuation, or in investments with moderate risk profiles, e.g. a non-tech business with a solid operating history.
- **Convertible Notes:** Convertible promissory notes are a *debt* security that is convertible into equity either at the option of the investor or upon a defined future event, such as the closing of a major equity investment round. Convertible notes are often used in *bridge financings* to help the company bridge the gap to an expected future investment round. The main advantages of convertible notes are that they may offer greater security to investors, and offer a way to side-step a negotiation over valuation of the company. The convertible note/bridge financing structure is not covered in detail in this Overview.

**When Important:** Always. The default assumption is that a venture capital financing will be structured as a Preferred Stock offering. A convertible note structure should usually be considered only in the bridge financing context. Investors will accept common stock only in exceptional circumstances, e.g. early “friends and family” financing rounds.

**Sample Language:** “Investors participating in the financing will receive shares of [Series A Preferred Stock] of the Company.”

## Liquidation Preference

**Definition:** A *Liquidation Preference* is senior right of investors holding Preferred Stock to receive some or all of the proceeds of a sale or liquidation of the Company. Liquidation preferences define how proceeds are allocated among the investors (holding Preferred Stock) and founders/employees (holding Common Stock or stock options).

**Variations:** Liquidation preferences come in two basic variations:

- **Participating liquidation preference:** A participating liquidation preference entitles the investor holding Preferred Stock to receive a defined amount per share before any proceeds of a sale or acquisition are paid to the holders of Common Stock. The remaining proceeds after payment of all liquidation preferences are paid ratably to holders of *both* Preferred Stock and Common Stock.
- **Non-Participating liquidation preference:** A non-participating liquidation preference offers holders of Preferred Stock a senior right to payment of a defined amount per share, same as a participating preference. However, in this case the remaining proceeds are paid *exclusively* to the holders of Common Stock with no further “participation” by Preferred investors. The net effect is that investors may elect to be paid their preference if the Company is sold or liquidated at a valuation per share *less* than their liquidation preference, or they can elect to simply participate in the proceeds ratably with the Common Stock if the Company is acquired at a valuation higher than their liquidation preference.

There are a number of common sub-variations within these two main structures, including the following:

- **Liquidation Multiples:** The amount of the liquidation preference is often 1X the amount of the original investment per share, but liquidation preferences of 2-3X, or (1X + an annual rate of return), are not uncommon.
- **Capped Participation:** A liquidation preference may be a participating preference up to the point where investors have received a defined multiple of their original investment, then switch to a non-participating preference for higher valuations.

**When Important:** Always. Liquidation preferences are usually the main structural determinant of the investors' ultimate ROI. This is often a heavily negotiated point. A 1X participating preference is the most common structure, but non-participating preferences are often appropriate for early-stage (and very late stage) investments.

#### Sample Language:

- **Participating preference:** "In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of Common Stock an amount equal to xxx% of the Series A Price, plus any [declared/accrued] but unpaid dividends (the "Preferential Amount"). After payment of the Preferential Amount to the holders of the Series A Preferred, any remaining proceeds thereafter shall be distributed ratably to holders of the Preferred Stock and Common Stock, based on the number of shares held on an as-converted basis."
- **Participating preference:** "In the event of any liquidation or winding up of the Company, the holders of the Series A Preferred shall be entitled to receive in preference to the holders of Common Stock an amount equal to xxx% of the Series A Price, plus any [declared/accrued] but unpaid dividends (the "Preferential Amount"). After payment of the Preferential Amount to the holders of the Series A Preferred, any remaining proceeds thereafter shall be distributed to holders of Common Stock."

## Anti-dilution Rights

**Definition:** Anti-dilution rights are a mechanism that helps shield investors from the dilutive effect of any share issuances by the Company subsequent to closing their investment, at the prices lower than the price per share paid by the investors. Anti-dilution rights operate by making the investor eligible to receive a greater number of shares of Common Stock upon any conversion of their Preferred - this effectively raises the investor's percentage ownership in the Company to counteract the effect of the dilutive share issuance.

**Variations:** Anti-dilution rights usually fall in one of the two following categories:

- **"Weighted average formula" anti-dilution:** The most common anti-dilution rights increase the investors' Preferred conversion ratio using a standard formula that takes into account both the price of the dilutive share issuance and the magnitude of that issuance relative to the Company's overall capitalization. The net effect of the adjustment is that the investor's shares are "re-priced" to a level somewhere between the original investment price and the price of the dilutive issuance.

- **Full-ratchet anti-dilution:** A “full ratchet” anti-dilution formula effectively “re-prices” the investor’s investment to match the pricing of the subsequent dilutive issuance. The full adjustment kicks in regardless of the amount of the dilutive issuance.

Another point of negotiation is often over categories of shares issuances that are *exempt* from the triggering an anti-dilution adjustment, such as issuances of Common Shares or stock options to employees under incentive compensation plans.

**When Important:** Anti-dilution rights are always at least moderately important. Investors should typically negotiate at least weighted average anti-dilution rights. A full ratchet provision may be appropriate in cases where investors are accepting an aggressive valuation or where the Company’s ability to raise additional funding is very uncertain.

**Sample Language:**

- “The Preferred Stock conversion ratio will be subject to anti-dilution adjustment based on a standard [broad-based weighted average formula] [full ratchet adjustment formula], in the event of stock issuances at less than the Series A Price.”

## **Dividend Rights**

**Definition:** Preferred stockholders almost always have a dividend preference, which is a right to payment of dividends on their shares before the Company can pay dividends to holders of Common Stock.

**Variations:** Dividend preferences differ based on two factors: (1) what triggers accrual of dividends, and (2) when dividends must be paid. Typical provisions include the following:

- **Non-cumulative Dividend Rights:** Non-cumulative dividend rights simply provide that the Company must pay a stated dividend to holders of Preferred (usually 5-10% of the original share purchase price) in any fiscal year, if (and only if) the Company’s Board declares any dividend on the Common Stock during that same fiscal year. After payment of the dividend preference, holders of Preferred are also entitled to a pro rata distribution equivalent to the distribution on the Common Stock. However, there is no dividend entitlement if the Board declares no dividends. This is the most typical structure for technology companies, which rarely pay dividends.
- **Cumulative Dividend Rights:** Like non-cumulative dividend rights, cumulative dividend provisions do not require payment of any dividend unless elected by the Board. However, to the extent a dividend at the stated preference rate (e.g. 8%) is not paid in any fiscal year, the amount of the dividend preference accrues and is carried over to the next fiscal year. Accrued dividend preferences must typically be paid in cash at such time as the Company starts paying dividends. Another common structure is to have accrued dividends added to the holders’ liquidation preferences - such that the preference amount payable in a sale or liquidation is the original purchase price plus all unpaid cumulative dividends.
- **Mandatory dividends:** Preferred shares could have a mandatory dividend feature, meaning that minimum dividend payment must be made every fiscal year, whether declared by the Board or not. A mandatory dividend requirement is relatively rare for an emerging growth company, but could be justifiable for a mature business with predictable cash flow.



**When Important:** Dividend rights are usually not a heavily negotiated term, based on the assumption that emerging growth companies will rarely have the ability to pay cash dividends. However, early stage investors should consider requiring cumulative dividend rights. If there is an expectation of holding the investment for a number of years through to a liquidity event, cumulative dividend accrual could significantly change the ROI profile of the investment.

**Sample Language:**

- *Non-cumulative Dividend:* “The holders of the Series A Preferred Stock shall be entitled to receive non-cumulative dividends payable in preference to any dividend on the Common Stock, if, when and as declared by the Board of Directors. Such dividends, if any, shall be at the rate of eight percent (8%) of the Purchase Price per share of Series A Preferred per annum.”
- *Non-cumulative Dividend:* “The holders of the Series A Preferred Stock shall be entitled to receive dividends payable in preference to any dividend on the Common Stock, when and as declared by the Board of Directors, at the rate of eight percent (8%) of the Purchase Price per share of Series A Preferred per annum. If not paid in any fiscal year, such dividends shall accrue and shall be payable on a cumulative basis in preference to any dividend on the Common Stock.” [Note: The Liquidation Preference definition should also refer to including accrued but unpaid dividends in the preference.]

## **Protective Voting Rights**

**Definition:** Holders of Preferred Stock are ordinarily entitled to approval rights with respect to defined list of corporate actions. These special voting rights are intended to preclude the company from taking actions that adversely affect the rights or economic position of the investor group.

**Variations:** Term sheets will ordinarily contain a list of matters that the Company may not undertake without the prior consent of holders of a majority (or supermajority) of the Preferred shares.

Typical matters requiring approval include the following:

- Any change in the rights and preferences of the Preferred Shares
- Issuing a class of equity securities senior to (or in some cases on a parity with) the existing Preferred Shares
- Sale of the Company (in some cases subject to a minimum acquisition valuation)
- Payment of dividends or redemption of shares
- Incurring debt in excess of a stated amount
- Increasing the number of shares authorized under the Company’s incentive plans
- Changing the size of the Board of Directors.

**When Important:** Generally always important to have a basic set of protective voting rights. The importance of these rights diminishes somewhat if the Preferred holders control a large percentage of the combined vote of all shareholders, or if the investor group is heavily represented on the Board of Directors.

**Sample Language:** “The consent of the holders of a majority of the Preferred, voting as a separate class, shall be required for any action involving the following matters: ....”

## **Board Representation**

**Definition:** Investors will often negotiate the right to appoint one or more members of the Board of Directors, allowing investors to directly influence and oversee management of the Company. Among other powers, the Board of directors has the right to hire and fire officers, set operating budgets, and approve material transactions and expenditures.

**Variations:** The main negotiated variable is the number of Board seats to be controlled by investors. A common arrangement is for holders of Preferred Stock to control a defined number of seats, holders of Common Stock to control a certain number of seats, and for one or more independent directors to serve on the Board, with no constituency holding a majority of the votes. Even in instances where the holders of Preferred do not control a majority of the Board votes, approval of the directors appointed by investors may be required for certain critical matters.

Several mechanisms may be used to assign Board representation rights:

- The Company's charter may specify that certain directors are to be elected by holders of Preferred Stock voting as a separate class.
- The investors and founders may enter into a voting agreement, whereby they collectively agree to vote to elect a Board with an agreed composition.

**When Important:** Board representation rights are an important consideration in most investments in early stage companies, particularly in the case of companies with less experienced management teams. Board representation may be less critical in mature business, or in cases where investors control a relatively small portion of total equity.

Investors should also carefully consider whether they wish to undertake the duties and responsibilities of serving as a director. Importantly, directors owe a fiduciary duty to act for the benefit of all the Company's shareholders, and not place their personal interests ahead of those of other shareholders. Accordingly, investors may wish to avoid board roles:

- in cases where the investor's interests could often be at odds with those of the Company as a whole
  - if the Company is unable to purchase adequate director liability insurance coverage.
- if the investor is unable to devote significant time and attention to their role as director.

**Sample Language:** "Holders of Preferred Stock shall be entitled to vote as a separate class to cause to be elected the [two] directors nominated by a majority in interest of the Preferred."

## **Redemption Rights**

**Definition:** A *redemption right* is a right to cause the issuer to repurchase shares held by an investor after a certain period of time or based on certain contingencies. Redemption rights may offer an additional path to liquidity for investors in cases where other exit opportunities do not become available.

**Variations:** There is no set structure for stock redemption rights, and several variables are subject to negotiation:

- **Triggering Events:** Most often, redemption rights become exercisable after a certain number of years following the investor's original investment date, if the company has not been

acquired or gone public during the specified period, which will typically range from 5 to 7 years. They may also trigger if the Company fails to meet certain performance milestones within a defined period.

- **Triggering Vote:** Redemption of class of shares may be triggered by a vote of a majority (or supermajority) in interest of holders of that class, or individual investors may have the right to independently elect to have their shares redeemed.
- **Redemption Price:** Investors may simply receive the amount of their original investment upon redemption, or their original investment plus an annual rate of return, or in some instances a multiple of their original investment amount.
- **Redemption Period:** The Company may be required to immediately redeem all shares held by investors upon the occurrence of the trigger event, or the Company may be permitted to redeem the shares in installments over a period of several years. It is important to note that state law may preclude companies from redeeming shares if their financial condition does not meet specified criteria, in which case the redemption obligation is typically deferred until the Company's financial condition improves to meet the statutory standard.

**When Important:** Early stage investment rounds provide for redemption rights relatively rarely. They are relatively more important to bargain for in instances where other liquidity opportunities (acquisition, IPO) are less likely to materialize, e.g. in the case of family-owned businesses, or businesses without strong proprietary technology or other salable assets.

**Sample Language:** “Commencing on the fifth anniversary of the issuance of the Series A Preferred, holders of a majority of the outstanding shares of Series A Preferred shall have the right to require the Company to redeem their shares for cash at the original purchase price, plus a xxx% annual rate of return, compounded annually.”

## **Preemptive Purchase Rights**

**Definition:** Preemptive rights (also referred to as “rights of first refusal”) allow investors the option of purchasing a defined percentage of securities offered in future financing rounds, in order to maintain their percentage ownership interest.

**Variations:** Preemptive rights follow a fairly standard structure. The main negotiation points are typically:

- **Pro Rata Allocation formula:** The number of shares an investor is entitled to purchase in a subsequent financing is typically based on that investor's current percentage ownership interest in the Company. In some cases the allocation is based on ownership as a percentage of the Preferred class only, in other cases based on total shares outstanding, and occasionally on the Company's fully diluted capitalization.
- **Exclusions:** Preemptive purchase provisions often include several categories of securities issuances that are excluded from investors' preemptive rights, e.g. shares issued pursuant to employee incentive plans and shares issued in acquisitions of other businesses. The scope of these exclusions is a negotiation point.

**When Important:** Preemptive rights are rarely controversial. Having a robust preemptive rights provision can be helpful in instances where substantial dilution is anticipated and/or where the financing is aggressively priced. Preemptive rights can also be an important protection where

investors perceive a risk of the company undertaking transactions with related parties on preferential terms.

**Sample Language:** “Holders of Series A Preferred will have the right to purchase a pro rata portion of securities offered in subsequent financings by the Company, subject to customary exclusions. The pro rata portion of each holder will be based on the percentage of the Company’s outstanding capitalization held by such holder.”

## **Rights of First Refusal**

**Definition:** Investors will often expect an option to purchase any shares of the Company that one or more of the founders decide to sell. Pursuant to a *right of first refusal*, founders are required to offer their shares first to the Company and to the investors before making them available for purchase by a third party.

**Variations:** Rights of first refusal tend to be based on a common structure, whereby each investor has a ratable right to purchase any shares offered for sale by the Company founders, with the Company often having a prior right of first refusal. The negotiable points include:

- **Allocation Formula:** Share allocations are typically based on each investor’s percentage ownership of the Preferred class. In some cases, any shares that an investor does not elect to purchase must be re-offered to other investors.
- **Exclusions:** Founders may press for certain exclusions from the first refusal rights, e.g. transfers to relative, trusts and similar related parties.

**When Important:** Rights of first refusal are typically not heavily negotiated. They will be of greater importance in instances where a share offering is oversubscribed and investors wish to maximize opportunities to pick up additional shares. These rights may also be important for strategic investors who wish to preclude unfriendly parties from acquiring an ownership interest in the company.

**Sample Language:** “All Founders shall be subject to a right of first refusal on transfer of their Shares. Any such shares shall be offered first to the Company, then to holders of Preferred on a pro rata basis, on the same terms offered to any third party.”

## **Co-Sale Rights**

**Definition:** *Co-sale rights* (also referred to as “*tag-along rights*”) require the Company founders to allow investors to participate in any sale of the founders’ shares to a third party - such that investors are allowed to sell a portion of their own shares to the third party buyer. Effectively, these rights require founders to “share” any liquidity opportunity with the investors.

**Variations:** Although co-sale rights are fairly common, they can be a significant negotiation point, as founders will perceive that they limit the founders’ liquidity opportunities. Some of the common variations include:

- **Exclusions:** Founders may press for limited exclusions from the investors’ co-sale rights, include a right to sell a defined percentage of their shares.

- *Application to Preferred:* Occasionally, investors will agree to themselves by subject to co-sale rights, for the benefit of either other investors only, or for the benefit of both other investors and founders.

**When Important:** Co-sale rights are desirable for investors in almost all cases. They offer the prospect of early partial liquidity opportunities, and also mitigate the risk of a key founder selling out to a new controlling shareholder that minority investors are less comfortable with.

**Sample Language:** “Any Preferred or Common proposed to be sold by a Founder to a third party will be subject to a Co-Sale Right. Under such Co-Sale Right, each holder of shares of Preferred shall have the right to participate in the sale of shares to the third party on a pro rata basis, on the same terms offered to the Founder who initiated the sale.”

## **Drag-Along Rights**

**Definition:** A drag-along right is a right of one group of stockholders (typically outside investors) to compel another group of investors (typically holders of Common Stock) to support a sale of the Company under specified circumstances. The purpose of the right is to mitigate the risk of the latter group obstructing a sale that is in the best interests of the shareholder base as a whole.

**Variations:** Any drag-along rights included in a financing structure tend to be highly negotiated, and customized based on the shareholder composition of the Company and other factors. Some of the key issues will include:

- *Valuation Threshold:* drag-along rights will typically take effect only in the case of a sale opportunity that meets certain valuation criteria. These may be based on the valuation of the Company as a whole, or the prospective returns on a per-share basis for various classes of stock. There may also be other structural requirements, e.g. an absence of liquidity restrictions or personal indemnity obligations in the acquisition deal structure.
- *Triggering Vote:* Triggering a drag-along mechanism usually requires a majority or supermajority vote of one or more classes of shareholders, e.g. a 2/3 majority of the Preferred as a class and a simple majority of the Common as a class.
- *Application:* Either the Common only, or both Common and Preferred holders may be subject to the drag-along mechanism.

**When Important:** Drag-along rights are not uncommon, but also are ordinarily not a “must have” for most investors. They can be an important factor in companies that have a fractious shareholder base, or in instances where investors perceive the founders are excessively wedded to their managerial roles and would unduly resist an attractive sale opportunity.

**Sample Language:** “In the event that a sale of the Company (whether by means of a merger, consolidation or stock sale, or a sale of all or substantially all assets of the Company) is approved by a majority of all outstanding voting shares of Preferred Stock and Common Stock of the Company, each holder will agree to vote all shares held by such holder in favor of such sale and tender such holder’s shares in connection with such sale.”

## **“Pay to Play” Provisions**

**Definition:** “Pay to Play” is a term used to refer to structures that impose a penalty on investors who elect not to participate on a ratable basis in subsequent financing rounds. Pay to Play provisions tend to be controversial - but are sometimes a useful device to promote cohesion within the investor group by motivating all investors to “step up” to provide additional financial support to the company when needed.

**Variations:** There is no single structure that serves as the norm for Pay to Play provisions. The common thread is that a negative consequence (usually a loss of rights or preferences) attaches to existing investors who elect not to purchase at least their pro-rata share of a subsequent securities offering that the Board of Directors deems fair and necessary to allow the Company to remain solvent.

Some of the mechanisms used include:

- Allowing investors who participate in a subsequent offering to trade their existing shares for a new senior security, or a security with other preferential terms.
- Causing investors who fail to participate in the subsequent financing to lose their Preferred rights and mandatorily convert into Common Stock.
- Allowing investors participating in the new offering to “re-price” their existing shares, such that non-participating investors incur substantial dilution of their percentage interests.

Note that Pay to play Provisions are usually not part of the original financing structure for an investment round. Rather, they are often adopted at a later date as a device to motivate investor participation in follow-on or bridge financing.

**When Important:** Pay to play provisions remain fairly uncommon. They are most appropriately used in cases where companies are undergoing difficult transition periods, and existing shareholders are the sole available source of follow-on funding. Often, “Pay to Play” provisions are required by a lead investor who wishes to ensure shared participation by smaller investors in the group.

**Sample Language:** “All existing Preferred holders will be afforded the opportunity to invest in the new financing round. If existing investors invest in this round at their full pro-rata participation level, each share of Series B purchased by them will allow the conversion and re-pricing of two shares of Series A into Series A-1 [senior class].”

## **Registration Rights**

**Definition:** Registration rights are a set of provisions that require the Company to register investors’ shares with the SEC for resale into the public market, in the event the company goes public. Registration rights can enhance the ability of investors, particularly larger institutional investors, to gain liquidity following an IPO.

**Variations:** Registration rights provisions tend to be lengthy and complex, but are rarely a point of extended negotiation. A basic set of registration rights that investors in a Preferred financing round should expect to receive include the following:

- **Demand Rights:** Demand rights entitle a defined subset of the investor class to require the company to file 1-2 long-form registration statement(s) covering the resale of some or all

their shares, following an IPO. In relatively rare instances, demand rights may include the right to compel a privately-held company to pursue an IPO after a certain number of years.

- **“Piggy Back” Registration Rights:** Piggy back rights allow investor to have some of all of their shares included in any registration filed by the Company for a primary sale of shares or a secondary sale by other shareholders, usually excluding the IPO registration.
- **“S-3” Registration Rights:** This is a supplemental right to cause the company to register investor shares using a short form registration process, which typically becomes available 12 months after an IPO.
- **Rule 144 Covenants:** Issuers will typically commit to taking various actions necessary to allow pre-IPO investors to sell their shares without registration pursuant to the SEC’s Rule 144 resale registration exemption.

**When Important:** Registration rights are rarely of great importance to angel investors, as modest interests in an issuing company can usually be sold relatively easily following an IPO without the need for an SEC registration. Nonetheless, investors should expect to receive most or all of the standard rights outlined above.

**Sample Language:** “In the event the Company effects an initial public offering of its Common Stock, the Investors shall be entitled to initiate up to two demand registrations, and to participate in any subsequent share registration of the Company so as to cause shares held by such Investors to be registered for sale to the public, subject to customary conditions and limitations.”

## **Warrant Coverage**

**Definition:** As additional consideration for their investment, investors will occasionally receive warrants to purchase additional shares of the target company. Warrants allow investors to increase their equity interest at a later time, thereby capturing a greater piece of the Company’s upside potential. Warrant coverage is relatively rare in equity financing rounds; but is very common in connection with bridge (convertible note) financings.

**Variations:** In instances where an equity financing includes warrant coverage, the key variables will include:

- **Amount of Coverage:** Investors will typically receive a number of warrants equal to a fraction of the number of shares purchased. Issuers will look to minimize the amount of coverage, as the warrants dilute the interests of existing equity holders.
- **Exercise Price:** Warrants will often be priced at the same level as the current funding round, meaning that the warrant holder capture the entire upside of any appreciation in the Company’s stock. However, warrants may be priced at a premium to the current valuation. In some cases, investors have received warrants to purchase Common shares at a lesser price than the current Preferred Stock valuation, allowing them to “average down” their investment price.
- **Term:** The exercise period for warrants can vary from three to ten years.
- **Cashless exercise:** Investors will often look to have warrants include “net exercise” provisions, that allow the warrants exercise to be paid by concurrently tendering back a portion of the shares purchased, eliminating the need for cash exercise price in cases where the shares have appreciated significantly.

**When Important:** Warrant coverage is simply a benefit that provides an additional incentive for investor participation in a financing round. It is most appropriate for investors to require warrant coverage in early stage equity investments of a modest size, or in connection with bridge financings, i.e. in high-risk investment contexts where investors require additional upside exposure to mitigate the heightened risk.

**Sample Language:** “Each purchaser shall be entitled to receive a warrant to purchase shares of additional shares of Series A Preferred of the Company at an exercise price of \$xxx per share, with the number of shares subject to such warrant being equal to xx% the number of shares of Series A Preferred purchased in the financing.”

## **Founder Terms**

**Definition:** Investment term sheet (particularly for Series A round investments) will often specify commitments to be made by the founders as condition to the investors’ investment commitment. Typically, founders are asked to agree to a vesting schedule for their Company shares, if none is already in effect. The intent is to ensure that key personnel have a strong retention incentive. Investors may require other concessions from founders, e.g. a commitment on reduced cash compensation to conserve cash through a subsequent financing round.

**Variations:** Customary vesting terms for founder stock may include:

- A 3-5 year vesting term based on continued employment with the Company
- Founders may receive vesting credit for their prior tenure with the Company, or for IP or other assets contributed to the Company upon formation.
- Accelerated vesting under certain circumstances, e.g. upon any involuntary termination of employment without cause, or upon an acquisition of the Company, or upon an acquisition followed by a termination without cause.

Other terms that may be required from founders and other key employees could include:

- Additional IP assignment agreements, if necessary to secure IP ownership in the Company.
- Partial deferral or reduction of cash compensation, if necessary to manage cash flow through a larger funding event.
- Commitments to recruit additional management talent and reallocate management titles and responsibilities.

**When Important:** Whether additional founder agreements and commitments are necessary will depend on the investors’ initial diligence. For instance, to the extent investors conclude that adequate retention incentives are already in place for key founders and officers, then additional vesting terms may not be needed.

**Sample Language:** “75% of the shares of Common Stock of the Company (and options to purchase Common Stock) issued to the Founders and to the Company’s Chief Executive Officer and other will vest in equal monthly installments over a period of 36 months.”



## **Closing Conditions**

**Definition:** *Closing conditions* are a set of actions that must be completed before closing the investment round. Once the investors and the Company sign the long-form stock purchase agreements, they commit to complete the investment on the condition that the closing conditions listed in the stock purchase agreement are satisfied.

**Variations:** Typical closing conditions an investor should expect to see include the following [note that closing conditions are often *not* spelled out in detail in the investment Term Sheet, but rather are left to be defined in the long-form stock purchase agreement]:

- Execution of all relevant agreements by the Company, the founders, prior investors and any other relevant parties.
- Amendment of the Company’s charter to authorize the Preferred shares to be issued to the investors.
- Completion of any required securities filings.
- Minimum funding amount for first closing
- Execution of any documents the investors are requiring from Company founders and employees, e.g. stock vesting agreements, confidentiality and IP assignment agreements in a form approved by the investors.
- Conversion into equity of any founder debt or bridge loans.
- Satisfactory resolution of any due diligence issues identified by the investors.

**When Important:** Closing conditions should ordinarily not be controversial. However, there recently has been a trend towards “staged” investments, where the investor capital is contributed in multiple tranches, based on completion of milestones or other conditions. If that is the case, then the funding conditions will need to be clearly defined and may be heavily negotiated. Funding conditions may include:

- Achieving significant customer wins
- Meeting revenue targets or other financial metrics
- Meeting developmental goals (or clinical milestones for biotech or medical device companies)
- Obtaining regulatory approvals
- Closing strategic partnering deals

**Sample Language:** “The Investors’ obligation to sell buy the Shares at each Closing is subject to the fulfillment on or before such Closing of the following conditions, unless waived by the Investors: ...”

## APPENDIX Q - Creative Deal Terms

This Appendix will be an ongoing work in progress that should develop over time. It may ultimately become a source of ideas for new deal terms that angel investors may, over time, begin negotiating into their investment terms.

**Please email to [duediligence@keiretsuforum.com](mailto:duediligence@keiretsuforum.com) your experiences and your ideas for provisions that might be added to future versions of this Appendix for the benefit of others.**

...

There are standard terms placed into investment documents such as term sheets and stock purchase agreements. Appendix O, entitled Common Deal Terms, Definitions, and Illustrative Text, highlights some of the basic and most commonly seen terms. Appendix T contains sample documents provided by the National Venture Capital Association as illustrations to help investors familiarize themselves with what the fundamental document types look like.

Many of the standard terms used to form the interrelationship between different classes of stock and sets of investors in different financings can evolve into quite complicated variations on otherwise fairly basic terms. This often happens in very capital-intensive emerging companies that require multiple financing rounds with interim closes that do not quite meet the company's needs, leading to a tug between very influential existing investors who invested quite heavily and newer investors who end up with a lot of leverage. The Boards of these companies can end up becoming quite creative in creating new and complex evolutions of some of the basic deal terms that are illustrated in Appendices O and T.

...

This Appendix is not about those types of evolutions of typical terms.

*Rather, this Appendix is a combination of a very light-hearted yet very serious creation of brand-new types of deal terms that investors might one day negotiate into agreements with companies in which they invest.*

Most every early stage investor has at one point or another been seemingly blind-sided by something they had not considered, and ended up with a lesson to share with other investors. Moreover, everyone who has had one (or more) of these experiences can now think of a provision that ... had it been put in place as a condition of making their investment ... might have headed off the problem before it caused the harm, a lot of heartache, a significantly reduced ROI, or even a total loss of the principal they invested.

This Appendix will, perhaps, become a format for an "open-source" creation of new terms, created by investors and then eventually taken to attorneys to develop. It will be updated and incorporated into this Handbook for others to see. Of course, if you use them and they result in problems, the same disclaimer that applies to this entire Handbook also applies to the use of these terms. Consult an attorney before using anything you see here.

This is being created in the spirit of The Keiretsu Forum's approach to Mindshare, though it does not necessarily reflect the seriousness with which Keiretsu Forum members treat their investment decisions.

. . .

The first one was provided by a Keiretsu Forum member from the Pacific Northwest who invested in a company co-founded by two people: a high-caliber entrepreneur and executive who had built a national brand that most everyone in the United States recognizes. His co-founder should have been happy to learn from him and join in what might have been a successful liquidity event. Instead, this young co-founder disagreed with his strategy and decided to attempt to remove him from the CEO role. This resulted in a proxy fight just as the company was entering a new funding cycle. The company could not raise money in the midst of the battle, ran low on cash, and ended up receiving capital in a major cram-down by a venture firm that put their own CEO in charge. The investment had been made in large part to invest in the now former CEO as he was building a new product line and brand in the same industry in which he had previously had massive success. The DD Team had done a thorough job. But, nobody could have imagined this set of events unfolding.

Co-founders do seem to routinely fall into problems with their relationship. The healthy partnerships among co-founders that gave rise to Hewlett Packard, Google, and eBay, among others, do seem to be more of an exception than a rule.

**A Mutually Assured Destruction co-founder term** might be a solution. The reference comes from political scientists who coined this term during the Cold War. Neither the U.S. nor the U.S.S.R. would launch an intentional nuclear first-strike, given that the inevitable outcome would also be their own destruction. Such a term might provide that both co-founders would lose all of their stock if one tried to either remove the other or demote the other's role.

**Please email your suggestions for additions to [duediligence@keiretsuforum.com](mailto:duediligence@keiretsuforum.com).**

# Appendix R - Valuation Methodologies: An Imperfect World

This article was written in 2010 by Keiretsu Forum member and The Keiretsu Forum Founding Region's Due Diligence Committee member Catherine Chiu.

In reaching for the “proper” valuation of startups, one must first recognize that no valuation method works all that well. The best is “comparable deals”, and this presumes that the investor is in the market frequently, sees a fair number of startup companies at similar stages of growth getting funded in the current market environment, and has access to the valuation information for such companies.

Below are several possible methodologies that aid an investor in assessing possible valuation. Each of the methods begins with projected financial performance, and therein lies the fundamental problem of startup valuation, namely choosing the proper financial projections on which to base one's valuation analysis.

## Comparable Public Valuation

The most common valuation methodology for companies is to review a set of “comparable companies” in the public market. This is the easiest, and in many ways fairest way to determine how the public markets view a particular sector/ company. Note that this example is used primarily for mergers & acquisitions, thus “Enterprise Value” is used in lieu of “Equity Value” (Enterprise Value = Equity Value + Total Debt - Cash.) To analyze market comparables of stock valuation, one needs only to review the total Equity Value of a company.

### a. How

Select the Comparables. Select a number of companies that are in the same sector, offer similar types of products, and whose business profiles are similar to the target company being valued. If the universe of companies is sufficiently large to offer a choice, selection should be based on the following considerations: size (smaller the better to emulate target company), sector dynamics (even companies in the same sector often focus on different parts within that sector), recent performance (target company is likely to be highly risky, so pick companies in the sector that have similar challenges).

Analyze Market Multiples. The fairest reflection of value is typically price/earnings multiples (P/E”). However if the sector is subject to unusual tax (international entities) and depreciation and amortization (asset rich companies) charges, or if the sector is primarily driven by cash flow, then EBITDA multiple may be used. For startups that will not show profit for some years, revenue multiples may be used, though this is typically a poor way to value public companies. To figure out the earnings multiple, take a company's current stock price, and divide it by Net

Income per Share (use fully diluted shares disclosed in the financial documents). For a revenue multiple, divide the stock price by Total Revenues per Share (fully diluted shares).

Forward or Backward Earnings? In the public market you can usually find forward earnings estimates, and calculate forward earnings multiples for the comps. For a startup company, this may be a much more relevant measure than P/E calculated based on the latest twelve months (“LTM”) performance.

Know Your Comps. In analyzing comparable companies, it is important to note that each comp has its own set of circumstances, unusual charges, industry position, etc. Professionals often dive into the “MD&A” (management discussion and analysis) section of the financial disclosure documents to “adjust” for any unusual, one-time charges in order to get a “fair” set of multiples. The angel investor would not typically do this type of exhaustive work, since the multiples from public markets offer only a rough benchmark at best, and sometimes are way too rich for a startup company, whose challenges and risks are substantially higher to warrant similar multiples (see “Qualitative Considerations” below.) However a quick review of financial analysts’ reports would provide better understanding about why a company’s earnings (or revenue) multiples are what they are.

## **b. Applying the Comparable Multiples**

What Numbers to Use? Typically, startup management is highly optimistic, does not consider all the risk factors facing them (or they would not be starting a company!) and over-inflate what is achievable. The more inexperienced the entrepreneur (for the sector, for starting a company, or for not having managed all the disciplines that (s)he will be called upon to manage in the role of CEO), the more inflated the numbers.

DD. This is where DD comes in. The investor must understand the potential, but realistically assess what it will take to achieve the promise. Based on the DD, the investor may apply a discount to the supplied projections, stretch out what has been promised, or develop his own projections.

Valuation. Take the average of the comparable companies’ earnings or revenue multiples, and apply it to, say, what can be achieved in 18 - 24 months (typically, entrepreneurs have a reasonable horizon of 18 months, beyond which they cannot see, nor can the investor.) That provides a reasonable indication of a public market valuation. Discount that value back by the period of elapsed time to arrive at a reasonable current valuation. The discount rate that you apply should take into consideration your assessment of the level of risks the particular startup faces, based on your DD work. Typical public companies use a discount rate of 12% - 15% for internal projects. If the company has access to substantially lower cost of funds (e.g. bank borrowing) then these rates could be lower. For a startup, a discount rate of 25%, or substantially more, is not unreasonable.

Private Market Discount. Discount the value further for the startup’s lack of access to public markets liquidity. The liquidity discount is typically 20% - 40%.

### c. Other Qualitative Considerations

Startups being funded by angels are no public companies. The things that must happen before these startups can hope to become a public company are many, subject to huge risky assumptions, etc. Thus the public market is not really a good place to seek comparable valuation, unless the private company being valued has a reasonable prospect of becoming public within 18 months. Thus this method is more appropriately used by private equity firms investing in the mezzanine round, not angels investing in Seed, Series A or B. If a startup company presents their valuation thoughts by comparing themselves to public companies, you know the valuation is way, way too rich.

## Comparable Exit Valuation

This method is very similar to the comparable public company valuation, but looks to comparable valuation in the mergers & acquisitions space. Exit valuation is an appropriate benchmark for startups if the exit is expected to be a sale to a larger entity. In this case, the investor looks at what valuation could be achieved on exit, at what time (how many years out), and discounts the achievable value back to present to arrive at a reasonable valuation.

### a. How

Find Comparable Deals. Search for deals in the same sector, or done by potential acquirers of your target company. Often this information is difficult to find, but industry analysts have a way to discover that info. Besides press releases, look for in-depth analyst reports.

Analyze the Multiples Paid. The relevant metric is Total Enterprise Value (“TEV”): LTM Earnings (or LTM Revenues).  $TEV = (Equity\ Value + Debt\ Assumed - Cash)$ . If the acquisition includes substantial debt assumption, the equity value should be calculated based on above formula. An angel investor should only expect to get the equity value, not the TEV.

Discount Back to Present. Remember this method provides the exit value of a startup, assuming all go well and an exit is reached. Apply the appropriate discount rate based on appropriate risk assessment.

### b. Qualitative Considerations

Frequently the multiples paid for in acquisitions are fraught with specific circumstances / considerations that that pertain for both the acquirer and the seller. Thus each deal comes with its own set of factors and issues, and may not provide an accurate read on potential valuation that may be paid in the future for the target startup. Also, small acquisitions by large companies often are reported but the acquisition value is not disclosed, depending on whether the deal was considered “material”. Thus data may not be available.

This method may be used in conjunction with the public markets valuation to provide an investor with comfort as to the range of possible valuation payable within the same sector.

**Example:** Below is a table that shows acquisition valuation of a group of software companies that took place during a period in time. Also see valuation matrix assembled for valuing an IT service company. Note that, to estimate value, professionals consider a variety of metrics before deciding on a range. In M&A, enterprise value based on multiples of EBITDA is often used in

situations where operating cash flow best provides indication of operating performance. In other cases it may be appropriate to EVP multiples based on EBIT or net earnings.

Enterprise Application Software Transactions Over \$500M, 2008-2009; Source: Udata Advisors, Inc.

*Source: Udata Advisors*

Date Announced	Seller	Buyer	Deal Value (in millions)	EV/TTM Revenue Multiple	Vertical
15-Sep-09	Omniture Inc.	Adobe	\$1,800	5.1x	Business Analytics
28-Jul-09	SPSS Inc	IBM	\$1,170	2.9x	Business Analytics
22-Jan-09	Interwoven, Inc.	Autonomy Corporation plc	\$775	2.3x	Enterprise Content Management
15-May-08	D+S europe AG	Apax Partners Worldwide LLP	\$530	1.5x	Customer Relationship Management
31-Mar-08	Ansoft Corporation	ANSYS, Inc.	\$832	8.2x	Product Lifecycle Management
22-Jan-08	Exstream Software LLC	Hewlett-Packard	\$700	7.8x	Enterprise Content Management
08-Jan-08	Fast Search & Transfer AS	Microsoft Corp	\$1,231	6.5x	Search and Retrieval

## Discounted Cash Flow

The DCF (discounted cash flow) analysis is often used in conjunction with one of the above methods, to provide yet another view about how investors reach their returns. Rather than using this as a way to value a company, DCF may be a useful tool to estimate an investor's returns, depending on their view of the possible exit values.

### How It's Done

**Computing IRR.** To calculate the internal rate of return ("IRR") for a series of cash flows, the best way is to use an Excel spreadsheet (use the "IRR" function), as IRR calculation is an iterative process. However if an investor has no cash flow between the time of initial investment and future return, this calculation is much easier: simply calculate the compound rate of return (typically compounded annually) based on the future exit value of the company. In this case you are really using the Comparable Exit Valuation methodology.

**DCF as a Valuation Tool.** The DCF model is appropriate for cash flow plays. If a startup (or more typically a real estate deal) is primarily a cash flow investment, and the investor expects cash back from the investment annually, then the DCF model is appropriate for analyzing valuation and returns. To do this, put into the Excel model the investor-scrubbed financial projections, down to the expected cash payments from the startup, over the relevant investment period. There needs to be an "ending value" for this model, unless one expects the investment to have no end date. The ending value is typically what the entity could be sold for, or what the contracted exit value is (the negotiating team should negotiate some kind of exit, the valuation of which should be spelled out.)

**Discount Rate.** The biggest issue with using the DCF model is to select the appropriate discount rate. If one were calculating returns, one specifies the expected payouts and computes the rate of return. If one were deciding on proper valuation using DCF, then one enters the discount

rate to compute what is considered “fair value” today. Startups are stacked with risks and often the discount rate applied must be very high. However if the cash flow is relatively predictable, like in the case of a real estate investment, then the discount rate is typically much lower. Even then, typical expected real estate equity returns at Keiretsu, after expenses and profit sharing, are generally north of 18%. This should provide angel investors an appreciation for the discount rate required for a startup in other sectors.

## **Comparable Deals Valuation**

Venture Capitalists, especially ones in early-stage deals, rely most heavily on “gut” developed from frequent exposure to comparable deals. “Comparable” means similar stages of development (e.g. has there been market adoption?), similar business models (SaaS and manufacturing plays are very different models,) similar sectors (sector dynamics and cyclicity issues), entrepreneur’s perceived business savvy and relevant industry/ operating experience, strength of the team, and many other qualitative factors. Just as M&A deals are frequently subject to similar “comparable deal” analysis, private equity deals have their own sector dynamics. Whether the investor is funding to cash flow or funding to product launch makes a very big difference on price, because the level of risks are substantially different.

Thus it is reasonable to ask fellow angel investors whether a Series A deal is “typically” valued at \$3 - 5 million, or \$5 - 8 million, depending on all of the above qualitative considerations. The investor then applies DCF or comparable exit valuation to evaluate whether (s)he is fairly compensated for the risks undertaken. In this approach, access to more deal valuation is invaluable, and an organized approach to collect valuation information by an angel organization, including commentary that provides a perspective on the above qualitative factors that went into the valuation, would be highly recommended.



# Appendix S - A Better Techniques for Disciplined Venture Investing

The following article was provided to The Keiretsu Forum by Steven Kam and Jason Ruiz of Hamilton Venture Advisors.

# A Better Technique for Disciplined Venture Investment Decisions

*An Article for Keiretsu Forum*

By Steven Kam and Jason Ruiz

*Section One explores the application of net present value and internal rate of return analysis to assist in choosing between alternative early-stage investments. Section Two develops the principle of value based on rates of return by exploring the difference in reasonable expectations between the venture and mature stages of companies.*

## ***Section One***

### **A Primer on Interpreting Forecasted Investment Returns for Non-Branded Ventures**

*An investment decision in venture stage companies should not immediately follow the disclosure of the entrepreneur's "win-win" proposal of a 5 to 20-times return on investment—regardless of whether his business model and cash flow projections appear reasonable or even believable. Assuming the industry, the company, the cash flows, and the deal are attractive, additional thought and comparative economics are necessary, especially for a minority investor that has no influence on the operations of the business or the power to force liquidity from the investment. Business valuation, which is grounded in fundamental corporate finance theory, incorporates discipline, critical thinking, and empirical data to make informed investment decisions that coincide with specific investor parameters and return requirements.*

The potential return on investment from early stage companies is a major selling point and highlight of entrepreneurs and/or private equity fund managers. But, assuming every aspect of the business plan has been thoroughly addressed, the investment decision should not be made without defining the potential investment returns and alternatives. Capital budgeting (i.e. deciding how and which projects to commit investment capital) is an area of corporate finance and business valuation that can assist in clarifying the comparative economics of alternative investments. Specifically, it assumes that an investor has a finite amount of capital to invest and would necessarily choose between investment projects or deal structures—not unlike investing in early stage companies. A prudent investor would progress beyond the quantification of an overall investment multiple to measuring the impacts of investment risk (i.e., uncertainty of cash flows), holding period, and investment alternatives.

#### **The Methodology of Net Present Value Is A Better Model Than The Three Times Invested Capital v. Five Times Invested Capital Model**

Interpreting expected cash flows from an overall investment multiple to comparable investment returns, while being mindful of risk, holding period and investment alternatives, are the central factors of capital budgeting. One of the most useful concepts to measure cash flows and returns is a **net present value** ("NPV") analysis. For example,

assume you have the choice to invest in two comparable companies (with respect to target industry and stage of development):

- (1) **Company A projects a liquidity event that includes the payment of 3-times your invested capital in three years, or**
- (2) **Company B expects a liquidity event that includes the payment of 5-times on invested capital in six years.**

An NPV analysis promotes acceptance of any investment where the NPV is greater than zero (i.e., the net present value of the future cash flows exceeds the initial capital outlay). However, your investment capital limits you to invest in only one of the two companies. Which is the more attractive investment from a financial point of view, assuming a 40.0% required rate of return on venture investments for each year (see **Table I**)?

**Table I**  
**Basic NPV Analysis**

	Future Cash Flow Company A	Future Cash Flow Company B
<b>Year 0</b>	(\$100,000)	(\$100,000)
<b>Year 1</b>	-	-
<b>Year 2</b>	-	-
<b>Year 3</b>	\$300,000 <sup>1</sup>	-
<b>Year 4</b>		-
<b>Year 5</b>		-
<b>Year 6</b>		\$500,000 <sup>2</sup>
<b>NPV</b>	<b>\$9,329</b>	<b>(\$33,595)</b>

Based on the forecasted liquidity and holding period, *Company A with a significantly lower multiple of investment, is a better investment than Company B.*

### **What Is The Rate of Return of My Investment?**

Another useful capital budgeting tool that can be applied to alternative investment analysis is the concept of **internal rate of return** (“IRR”). IRR calculates the annual rate of return that the investment yields. Said differently, the discount rate that equates the present value of the investment’s future cash flows with the projects initial capital outlay—making the NPV equal to zero. Like the NPV, the computed IRR is influenced by the investment amount, the projected multiple of investment, and the holding period. *The basic premise of IRR analysis is to accept investments where the IRR is greater than one’s required rate of return (which is based on the investor’s opportunity cost of capital and often referred to as a, “hurdle rate”).* Using the example in **Table I**, the required rate of return is assumed to be 40.0% for investments of similar risk to Company A and Company B (i.e., early stage venture backed companies). **Table II** summarizes the calculated IRR based on the capital investment and projected cash flows of Company A and Company B.

<sup>1</sup>  $(\$100,000) + \$66,405 = \$9,329$ ;  $\$9,329 = \$300,000 / (1+40\%)^3$

<sup>2</sup>  $(\$100,000) + \$66,405 = (\$33,595)$ ;  $\$66,405 = \$500,000 / (1+40\%)^6$

**Table II**  
**Internal Rate of Return**

	Cash Flow Company A	Cash Flow Company B
<b>Year 0</b>	(\$100,000)	(\$100,000)
<b>Year 1</b>	-	-
<b>Year 2</b>	-	-
<b>Year 3</b>	\$300,000	-
<b>Year 4</b>	-	-
<b>Year 5</b>	-	-
<b>Year 6</b>	-	\$500,000
<b>IRR</b>	<b>44.2%</b>	<b>30.8%</b>
<b>Relative to</b>	<b>&gt;</b>	<b>&lt;</b>
<b>Required Rate of Return</b>	<b>40.0%</b>	<b>40.0%</b>

The 44.2% IRR of Company A exceeds the 40.0% required rate of return (and has a positive NPV see **Table I**) and should, therefore, be made. *The 30.8% IRR in Company B is below 40.0% the investor's required rate of return (and a negative NPV, see **Table I**). Thus, it should be rejected.*

It becomes obvious that the NPV or the required rate of return on an alternative investment should impact the investment decision, especially when comparing the NPVs and IRRs of multiple deals. More specifically, the derived IRR of the investment and of the alternatives should be adequately measured in addition to the business models, the expected cash flows, the liquidity assumptions, and the holding periods of each investment opportunity. At this point, the potential and the relative economics of the early stage investments have been disclosed, and it would be opportunistic to step back and reassess the major assumptions driving the returns to the minority shareholder—most important, the proposed liquidity and exit strategy.

### **Identifying Liquidity Assumptions**

Fundamental financial theory such as capital budgeting offers tools and translation of deal economics. But even if an investor's financial analysis and understanding of returns is complete, from the perspective of an investor, it is clear that the strength of any market-based valuation is only as good as the underlying market data that was utilized to determine the value of the company (e.g., comparable companies used, equity discount rate applied, profit margins forecasted, and pricing multiples of public companies utilized). The acid test for a potential investor is clearly identifying the liquidity assumptions put forth by the entrepreneur. *More specifically, what comparable companies were used to derive the five times multiple of investment? A mature company's size and risk are vastly different from the early-stage company. Large, well-known companies have established products and cash flow, which drive the magnitude of its capitalization multiples. Therefore, is the entrepreneur expecting to achieve the profit margins, the cash flows, and the eventual capitalization multiples of a large, branded company? If he is targeting a competitive industry and has used branded companies as proxies for liquidity, what adjustments should be made to the cash flow assumptions?*

Relying too heavily on branded companies for comparable pricing or financial modeling is aggressive, because it is the intangible value that consumers place on these companies that impact their profit margins and market value. For example, an investor should be cautious of an entrepreneur that uses companies like Microsoft, Coca-Cola, Starbucks, Amazon, E-Bay, etc. as a proxy for liquidity of his start-up. Despite the potential comparability or even superiority of a new product or service, *brand value drives companies such as Amazon and supports their pricing*—which is not the case for “Company A” or “Company B”. Moreover, CEOs, marketing managers, and even engineers can attest that a *strong brand can overcome “faster”, “better”, and “cheaper” early stage entrants*.

## ***Section Two***

### **The Market Pricing of Publicly Traded Branded Companies Is Not a Valid Valuation Model for the Pricing of Venture Stage Companies**

#### **Start-Up Companies that are Purported to be Valued Like Mature Companies**

I have asked that Entrepreneurs of start-up companies seeking venture funding incorporate in their presentation the *valuation rationale* to their stock price proposition. The basis for the price they would have investors pay should be well thought out, and *integral to their business plan* because the timing, circumstance, and expected pricing of the investor’s liquidity event is integral to the investment decision going in. Entrepreneurs of consumer product ventures often compare their potential enterprise to the best-known companies in their industry category. These are the most successful, fastest growing stocks with unlimited prospects, and the ones representing the most attractive investment imaginable. In essence they are saying that you may have missed investing in the last well-known opportunity that returned twenty times investors’ money, but their company should be view as another chance to get onboard of the next one. There is nothing wrong with that kind of boosterism and self-promotion if it ends there. Selling the belief to the audience is part of the investment process. But when the comparisons become unconstrained, they do not acknowledge that credulity is being requested as part of the investment decision.

Those big, well known companies often times have gotten to their current level through the deliberate and patient development of a **strong brand**. The power of a strong brand lies in its ability to influence purchasing behavior. Brands are a collection of perceptions in the mind of the consumer and therefore, can play a broad strategic role within a business.

#### **The Entrepreneur In Search of a Better Valuation Model**

Brands command market share, create options for growth, attract and retain talented employees, and promote shareholder value, thereby creating value for all stakeholders - customers, shareholders, and employees. *When companies create strong brands they are rewarded in the capital markets as well in the form of higher earnings multiples and lower required rates of return*. It is a huge burden the entrepreneur is foisting onto the potential investor when he asks the investor to assume the start-up company will achieve the same strong brand created by publicly traded companies used for comparison purposes. The entrepreneur requires this buy-in implicitly every time he points out that

those very high multiple of earnings the “comparable public companies” are trading at will be applied to the subject company in the liquidity event that will come in three to five years.

Specific expectations are attached to the dollar investment companies make into their brands. It is not a foregone conclusion that management will succeed in their mission to create this intangible asset. But when the evidence mounts and the business impact of a brand is evidenced, one of the best barometers is the ascent of shareholder value. How are stakeholders to know whether the company has created a brand? The following is a short list of telltale signs that some effort is creating acceptance, that the product is gaining a broadening audience, and that the audience is bonding with the product.

- **Strong Brands Grow Market Share**
- **Strong Brands Grow Revenue**
- **Strong Brands Build Shareholder Value**
- **Strong Brands Grow Profitability**
- **Strong Brands Reduce Business Risk**
- **Strong Brand Create Options**

### **Empty Comparisons**

The above discussion provides some of the basic principles regarding how an investor will know that brand is an operating business asset when its existence in a company is suspected. If a company has it, the market will value its stock with this asset in mind (along with all of the other assets the company holds).

### **What the Investor Gets for an Investment in a Branded Company**

Brand is a function of the promises a company makes of its products and the experience the consumer has regarding the products’ performance and delivery on those promises. Henry Ford said: “you can’t build a reputation on what you are going to do.” It is not a reasonable assumption today that a product with a strong brand will emerge out of the current investment round or even from future rounds. Therefore, the investor should not pay for this non-existent asset by way of high earnings multiples and low capitalization rates today when there is no evidence the company will ever achieve one. That price will be paid by future investors that invest in a company with more operating history than an early stage start-up possesses. Lastly, the following discussion summarizing a brand’s effect on cash flow develops the principle of what an investor receives when an investment in a branded company is made. It is these results from brands that deliver higher cash flows to investors, and warrant higher valuations today. Said differently, if your cash flows cannot now reasonably expect the following experiences, then the price you pay for these cash flows should not reflect them either.

**Brands Increase Cash Flow Streams** There is a demonstrated link between brands and shareholder value that stems from the most important driver of value—**cash flow**. Brands increase value by growing and protecting a company’s cash flows. Strong brands have been shown to command greater market share and in many cases, command premium prices. Brands can also reduce the sensitivity of the buying decision to increases in price.

Strong brands more readily access international markets and business areas (i.e., new products, services, market segments).

**Brands Accelerate Cash Flow** Brands accelerate cash flow by reducing the lead time required to turn investment into realized cash returns and increasing shareholder value because the holding period has been collapsed, thereby *reducing* the period over which the time value of money calculation diminishes the present value of future cash flows. Strong brands launch new products and services faster than weaker brands (or companies with no brand), because existing levels of awareness and trust facilitate consumers' acceptance. Strong brands may help to stimulate product innovation, further increasing the return on investment through new cash flows generated from product development.

**Brands Extend the Duration of Cash Flow** When a brand is maintained over a long time horizon it is known as a *cash cow*, extending the duration of cash flow from an investment. Asserting this proposition another way, we can see that maintaining a strong brand increases shareholder value because one of its intrinsic characteristics is a relatively higher level of customer loyalty, which is quantifiable through the *enduring cash flows* from those same customers.

**Brands Reduce the Uncertainty of Future Cash Flow** Brands' impact on shareholder value is felt nowhere greater than when it reduces the risk of future cash flows. This lower level of *uncertainty* (as we stated earlier, risk quantifies the uncertainty that a future event will occur) that anticipated cash flows will actually materialize increases in the value of these cash flows, which in turn creates greater shareholder returns. *Greater shareholder returns equate to greater shareholder value.*

Take from this discussion that well defended brands are known to lower the inherent risk in a business and may help companies deal with disruptions to their markets while creating barriers to entry for competitors thereby reducing the competitive threat to cash flows. ***Strong, well-maintained brands reduce uncertainty and increase shareholder value because they defend and enhance a business' cash flows. Investors in venture stage companies should require more that the entrepreneur's optimism that this intangible asset will materialize during the investment-holding period. Otherwise, in the absence of the evidence discussed in this article of brand creation, the investor should reduce the price he is willing to pay for undefended and unenhanced future cash flows. In that case, multiples of earnings of public companies with strong brands are inappropriate and should be ignored in the valuation process.***

*The preceding discussion borrows from material presented in The Business of Brands, By Jon Miller & David Muir, published by John Wiley & Sons Ltd., and Building Strong Brands, by David A. Aaker, published by The Free Press, A Division of Simon & Schuster Inc.*

# Appendix T - Company Value Drives The Value of Founders' Stock

The following article was written and provided to The Keiretsu Forum by Richard Bullen with contributions by Thomas Bondi, both of Berger Lewis Accountancy Corporation.



 **Company Value Drives the Value  
of Founders' Stock**

**An introduction to the concept of founders' stock  
and its value**

Written by **Richard Bullen**, Principal Business Navigation  
Contributions by **Thomas Bondi**,  
Principal Berger Lewis Accountancy Corporation  
Edited by **Jennifer Vessels**, Principal Next Step

Disclaimer: This white paper is intended to be used for illustration purposes only and in no way constitutes legal or financial advice. Readers are advised to seek professional advice from appropriate sources.

*The Classic Value Story*

*Had you purchased a single share of Cisco Systems in February 1990 for \$22, your investment February 2011 would be worth over \$2,657.*

High quality employees are the very lifeblood of today's successful companies. For this reason it is critical that founders and management know how to attract and retain people who are committed to a shared vision of company growth. The vexing question may be how does one create commitment? It is not just a natural trait, but often a response to critical motivators like a sense of shared ownership, personal reward, and the opportunity to participate in building a successful company. What is the key to unlock these motivators? Valuable stock options.

What makes a stock option valuable is the value of the company, so it's important that all employees be focused and aligned on increasing and maximizing this crucial metric. After all, which is more valuable—twenty percent of a bankrupt company or half percent of a company with a market capitalization of \$1 billion?

This white paper is intended as a primer on the value of a start-up company, how value is reflected in the share price and how to resolve the dilemma of dilution as funding and staffing are increased. It illustrates some of the important issues of stock valuation including critical calculations, and why company value is the super ordinate goal. However, the treatment is intentionally simplistic and readers should consult with their CPA, attorney, and stock plan consultant to develop their own cases.

To illustrate the points of interest, the following scenario describes a fictional start-up company and shows how the owners deal with some of the questions of stock and value as they progress from start-up phase to an IPO. The example does not represent a typical case, but is rather a compendium of some of the perplexing problems that founders might face.

A pre-revenue company whose owners cannot fund product development, marketing and staffing will often need "outside investment." They must consider how much money is needed and select the most favorable sources. For high technology companies, the primary source is venture capital. The amount of investment is determined by financial projections and may take anywhere from one to four infusions. Very often the total investment will require selling more than half the company and, hence, giving up control. Therefore, there needs to be careful consideration about how much money to take and when to take it.

With each infusion, which is called a "round of financing," founders and managers may face difficult questions, some of which will have a direct bearing on their personal wealth. It is important, therefore, to understand how the investment increases the value of the company, now or in the future, and what the investment will cost. As the example illustrates, the cost of capital can sometimes result in loss of control and will certainly result in a reduction of ownership.

### **A Fictional Study: Stock Ownership, Value and Dilution**

Imagine that five people start a company that intends to provide a knowledge management tool to help criminal justice agencies solve crimes. The unique selling proposition will be the ability to convert data to knowledge, and then use AI techniques to develop scenarios for how a crime may have been committed. Financial projections indicate a need for a \$10 million investment to complete product development, initial marketing and staffing.

## STOCK OPTIONS

### Market Valuations

The explosion in e-commerce requirements has spawned a new breed of consulting company that combines traditional IT skills, internet skills, cloud computing, and the necessary business skills to know how to implement e-commerce sites. The stock market sees great potential in these companies as reflected in their share price.

Take, for instance, Rackspace Hosting Inc. This company went public in August of 2008 and raised \$145M at its IPO. The second quarter of 2010 its revenues were approximately \$187M. Annualized, this would be \$748M. The company's market capitalization was approximately \$2.2B which gives a ratio of value to revenue of 3.

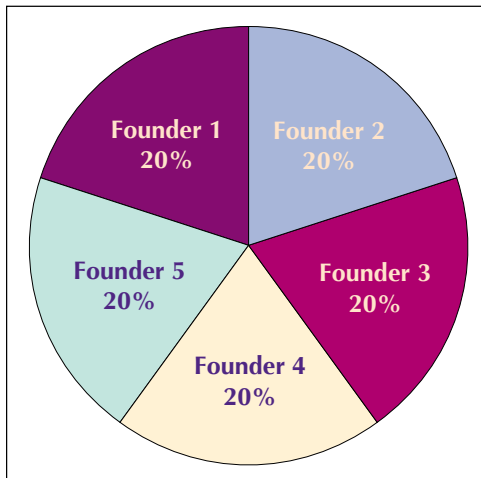


Chart 1: Founders' Ownership

### The Seed Round

The five founders enlist the help of an executive coach to help them think through the important issues in starting and managing their new company. The coach begins by counseling them on developing their vision, goals, and objectives and then reviews the stock structure and ownership.

As part of their visioning process they agree on a number of common "outcomes," one of which is that they each want to become financially independent as a result of this venture. With this in mind, their preferred goal is to create a publicly traded company, which means planning for an IPO.

With regard to each founder's company ownership, their coach suggests that before any other stock is sold or promised, they must make an agreement on the number of shares each founder will own. He argues that delaying this until after the company has grown or other people are involved can create friction among founders.

They incorporate as a "C" corporation and authorize 21 million shares. Each person agrees to make an initial investment of \$20,000 with a share price of 2 cents, giving each founder 1,000,000 shares (see Table 1). This is the seed investment of \$100,000.

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #2	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #3	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #4	1,000,000	\$0.02	\$20,000	20%	\$20,000
Founder #5	1,000,000	\$0.02	\$20,000	20%	\$20,000
Total	5,000,000		\$100,000	100%	\$100,000

Table 1: Founding Investment: The Seed Round

The coach, with an eye on quickly building company credibility, suggests that they form a board of directors comprised of two of the founders and three industry/business experts to assist in guiding their decision-making.

## STOCK OPTIONS

*The technically biased founders are keen to start product development, but their adviser stresses the need to always try to anticipate future financial requirements.*

### The First Round

The technically biased founders are keen to start product development, but their adviser counsels that the seed money will quickly be consumed and stresses the need to always try to anticipate future financial requirements. Two of the five founders take responsibility for seeking and raising additional funding while the others begin product development.

Through their networking and PR activities the two founders find a venture capitalist (VC) who will invest \$10 million in the first round, but with conditions. He thinks the product idea is good and the founders technically strong, but the team lacks management skills. He offers the investment on the following conditions:

1. Bringing in key managers, including a CEO, CFO and VP of Sales and Marketing.
2. Ownership of 51 percent of the company. The VC wants to reduce the investment risk by retaining control of important strategic and financial decisions.

Note that after this first round investment, 51 percent of the company is valued at \$10 million and, hence, the value of the company is now approximately \$20 million (see Table 2).

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000			10%	\$2,000,000
Founder #2	1,000,000			10%	\$2,000,000
Founder #3	1,000,000			10%	\$2,000,000
Founder #4	1,000,000			10%	\$2,000,000
Founder #5	1,000,000			10%	\$2,000,000
VC #1	5,204,082	\$2.00	\$10,000,000	51%	\$10,408,164
Total	10,204,082		\$10,000,000	100%	\$20,408,164

Table 2: First Round: Post-Money

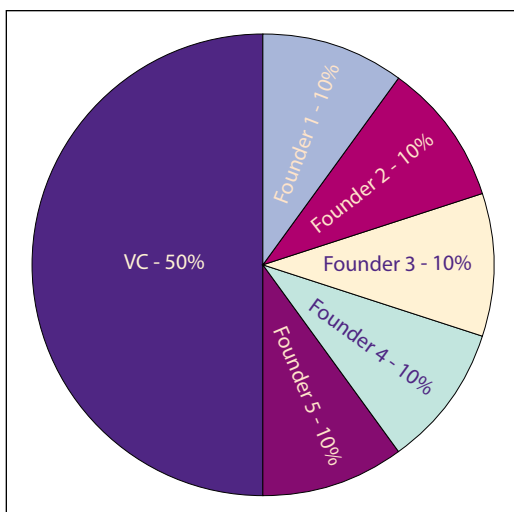


Chart 2: First Round Ownership: Post-Money

*Most investors consider the team to be by far the most important—common sense dictates if the team has good business sense, they will be in a good market with a good product.*

### Valuation and First Round Funding

The founders discuss with their advisor how much of the company they will have to sell for the \$10 million. Unfortunately for our fictitious team, they lack management skills and a track record of starting and building companies. Investors focus on: i) The Team, ii) The Market, and iii) The Product Idea. Most investors consider the team to be by far the most important—common sense dictates if the team has good business sense, they will be in a good market with a good product. The value the founders bring is reduced because they do not have a strong management team, and this is reflected in the investor demand for 51 percent of the company.

So now the founders are faced with the opportunity to get the investment they need, but it will cost them control of the company. What should they do? For some people this can be a hard decision, one that should clarify their commitments. Their adviser points out that they still have a lot to learn about running a company and much of that can be acquired in the current enterprise. He suggests that if they can successfully grow this company and take it to an IPO, it will leave them with the experience and the resources to start other companies. In effect they are getting paid to learn and still have an opportunity to significantly increase their personal wealth. The cost is giving up control. After long deliberations, they decide to accept the funding offer.

### Dilution

Selling part of the company creates dilution of ownership. After the investment, each founder's ownership share has been reduced from 20 percent to 10 percent, but the value of their holdings has not changed. Each now owns 10 percent of a \$20 million company, whereas previously each owned 20 percent of a \$10 million company. In the future, as the value of the company increases, so will each founder's stock value.

Investors	# of Shares	% Ownership
Founder #1	1,000,000	8%
Founder #2	1,000,000	8%
Founder #3	1,000,000	8%
Founder #4	1,000,000	8%
Founder #5	1,000,000	8%
VC1	5,204,082	43%
CEO	800,000	7%
CFO	500,000	4%
VP S&M	500,000	4%
Total	12,004,082	100%

*Table 3: Dilution Effect of Adding the Management Team*

Dilution may appear at first sight to be an undesirable sacrifice, but that perspective is very limiting and can sometimes restrict a company's growth. There are two factors which need to be carefully balanced when selling part of a company: the amount of ownership sold, and the value which is bought by the sale. The goal is to make sure that when stock is sold, the dilution effect is offset by an increase in company value. For example stock may be sold in return for an infusion of capital, the addition of key employees, or the addition of some critical asset like a strategic partnership.

## STOCK OPTIONS

*The goal is to make sure that when stock is sold, the dilution effect is offset by an increase in company value.*

The addition of the new managers is a good example of dilution bringing increased value. Three key managers are to be added to the team: a CEO, CFO and VP of Sales and Marketing. Since each of the managers hired has previous start-up experience, they will expect to make a substantial amount of money over and above their normal compensation. The total equity required to capture these three critical managers is 15 percent. Table 3 illustrates the result of adding these managers to the ownership list.

What is not shown “on paper” is the value that this team has added. This might easily be seen by considering future investment requirements. When more money is needed, new investors will take a strong look at the management team. It must meet some minimum requirements; but above that, the more prestigious the team, the more likelihood of a higher future valuation.

### Stock Incentives

Attracting and retaining new employees will require a stock option plan. As part owners of the company, people can feel that their efforts are making a difference, both to the company and to their own net worth. This provides great motivation for employees to make maximum possible contribution.

Unlike founders’ stock, the options program provides an opportunity for employees to capitalize on the growth in value of the company without such a high risk and high degree of commitment. With a stock option plan, employees are granted the option to buy stock at a fixed price. When the shares are traded on a public market, if the share price rises above this purchase price, there is an opportunity to realize substantial gains. Such options usually “vest” over a period of time, allowing employees to buy their options at the set price once they are vested. By setting this vesting period in the future, the company can use “Golden Handcuffs” to retain the committed contribution of employees.

These “golden handcuffs” are important in the attraction and retention of key talent. It is important to note that such stock options are created by setting aside a pool of shares from which options can be allocated. The dilution effects of such a pool are shown in Table 4.

Investors	# of Shares	% Ownership
Founder #1	1,000,000	7%
Founder #2	1,000,000	7%
Founder #3	1,000,000	7%
Founder #4	1,000,000	7%
Founder #5	1,000,000	7%
VC1	5,204,082	37%
CEO	800,000	6%
CFO	500,000	4%
VP S&M	500,000	4%
Options Pool	2,000,000	14%
Total	14,004,082	100%

*Table 4: Dilution Effects of Adding the Options Pool*

*As part owners of the company, people can feel that their efforts are making a difference, both to the company and to their own net worth. This provides great motivation for employees to make maximum possible contribution.*

### The Second Round

Product development continues, but as so often happens, challenges arise and the company misses deadlines. This delays the product roll-out, which in turn delays initial revenues. Now the company faces a cash flow problem as well as a lot of strategic problems, such as losing market share because they will be late to market. The investor insists that it's important to get into the market as early as possible, and requests a revised business plan showing how time lines can be moved up with the additional funding. The new plan indicates a need for an additional \$15 million investment. In spite of founder objections about further dilution, the board agrees to seek the additional funding; this is the second round.

### Valuation and the Second Round

Once again the board has to estimate the value of the company so that it can set a share price for the second round of financing. Since the company has met key development milestones and has an experienced management team, the risk of the investment is being reduced. This leads the board to expect a significantly higher company valuation. Significant signs of success might be demonstrating that the technology can be productized, that beta site customers are being signed up, and that no unforeseen significant problems have been discovered. The board assesses that although there is slippage in the development schedule, everything is going according to plan, and they decide to offer shares at \$6. Notice how the price to get into this deal has escalated from the original 2 cents with high risk, to a present \$6 with much reduced risk.

The initial investor decides to put a small amount into this next round, but asks the team to seek another investor to help spread the risk. The experienced management team has little trouble securing this additional investment. Table 5 shows the resulting dilution when this second investment is completed. It is important to note that the table shows a theoretical value of the stock; however, since there is no market on which to sell these shares, this is an “on paper” value.

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000			6.06%	\$6,000,000
Founder #2	1,000,000			6.06%	\$6,000,000
Founder #3	1,000,000			6.06%	\$6,000,000
Founder #4	1,000,000			6.06%	\$6,000,000
Founder #5	1,000,000			6.06%	\$6,000,000
Management	1,800,000			10.91%	\$10,800,000
Option Pool	2,000,000			12.12%	\$12,000,000
VC #1	5,204,082			31.53%	\$31,224,500
VC#2	2,500,000	\$6.00	\$15,000,000	15.15%	\$15,000,000
Total	16,504,082		\$10,000,000	100%	\$99,024,500

Table 5: Second Round: Post-Money

### Mezzanine Round

The company completes development, launches the product, and receives very good market acceptance. However, the cost of rapid growth starves cash flow—a common problem with emerging companies—and the company goes back to the private placement market for a mezzanine round of funding.

## STOCK OPTIONS

*One of the skills in navigating a company from start up to success is to reach a position in which the revenues exceed the total of the expenses, cost of future development, and required profits.*

One of the skills in navigating a company from start up to success is to reach a position in which the revenues exceed the total of the expenses, cost of future development, and required profits. Until that point is reached, the expenses must be covered by investment. Our fictitious company has consumed all its investment money completing product development and launching the product. Now there are insufficient revenues to “cover expenses.” This is a paradox because they are growing rapidly, have plenty of orders, and yet will not be able to pay their expenses without further investment.

The root cause of the problem is that the cost of increased marketing, expanded sales channels, and additional operations is more than the growing revenue can support. Eschewing other alternatives, the board decides their best option is to go back to the private market for another round of investment—a mezzanine round. They anticipate that this final investment will give enough momentum to make the company self-sufficient and position it for an IPO.

The mezzanine round is completed raising \$9 million at \$9 a share. Notice that if we price all outstanding shares at \$9, then the value of the company is approximately \$146 million. With sales at \$50 million per annum, this gives a ratio of value to revenue of approximately 3:1, currently a conservative figure for a company with a “hot” product. In addition, the value of the founders’ stock has increased considerably; compare Table 6 with Table 1 to see the increase in valuation.

Investors	# of Shares	Share Price	This Round Investment	% Ownership	Current Value
Founder #1	1,000,000			5.71%	\$9,000,000
Founder #2	1,000,000			5.71%	\$9,000,000
Founder #3	1,000,000			5.71%	\$9,000,000
Founder #4	1,000,000			5.71%	\$9,000,000
Founder #5	1,000,000			5.71%	\$9,000,000
Management	1,800,000			10.28%	\$16,200,000
Option Pool	2,000,000			11.43%	\$18,000,000
VC #1	5,204,082			29.73%	\$46,836,700
VC #2	2,500,000			14.28%	\$22,500,000
Investors	1,000,000	\$9.00	\$9,000,000	5.71%	\$9,000,000
Total	17,504,082		\$9,000,000	100%	\$157,536,700

Table 6: Mezzanine Round: Post-Money

The applications for the product are far wider than first anticipated and the company grows more rapidly than expected, but this brings new concerns. The company must now defend its position and attempt to stop any competitors from developing a “beachhead” into the market. To fund future investment opportunities the company decides to seek a further capital infusion through public investment. With this action the founders will complete one of the “outcomes” they envisioned when the company was started.

### Initial Public Offering

Becoming a publicly traded company brings significant changes, not the least of which is that in the future the results and operations of the company will be exposed to public scrutiny. The process of raising public money is also vastly different from a private placement. The company must find an



*The most critical factor for the offering will be the condition of the market.*

investment bank to underwrite the offering and manage the offering process. In this case, the board started interviewing investment banks early in the life of the company and has already selected and built a relationship with its first choice.

The most critical factor for the offering will be the condition of the market. Stocks of different types move in and out of favor so it is important for the IPO to occur when there is a strong demand for similar stocks. If the demand is weak, the initial share price can be depressed. Clearly, the bank cannot control the market, but prior to the IPO it does “show” the company to the market through a limited number of presentations in a nationwide “road show.” This process is intended to help create a “market” for shares of the newly public company.

The timing turns out to be good; in the two months prior to the offering several other companies with similar technologies have come on the market at \$18 a share and higher, and all analysts who follow this field are “bullish” on these companies. Anticipating strong demand the investment bank sets the initial price at \$20 a share for an offering of 3 million shares. Their acumen is fulfilled; the offering opens at \$20 and has risen to \$25 a share by close of market on the first day’s trading. The summary of the new valuation at the IPO is shown in Table 7.

Investors	# of Shares	Share Price	Initial Investment	% Ownership	Current Value
Founder #1	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #2	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #3	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #4	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Founder #5	1,000,000	\$20.00	\$20,000	4.88%	\$20,000,000
Management	1,800,000	\$20.00		8.78%	\$36,000,000
Option Pool	2,000,000	\$20.00		9.75%	\$40,000,000
VC #1	5,204,082	\$20.00	\$10,000,000	25.38%	\$104,081,000
VC #2	2,500,000	\$20.00	\$15,000,000	12.19%	\$50,000,000
Investors	1,000,000	\$20.00	\$9,000,000	4.88%	\$20,000,000
Public Sale	3,000,000	\$20.00	\$60,000,000	14.63%	\$60,000,000
Total	20,504,082		\$94,100,000	100%	\$410,081,000

*Table 7: IPO Valuation*

The company has now raised an additional \$60 million for future growth and expansion. In addition, anyone who owns shares now has an opportunity of selling them in order to realize personal gain; however, this is done with some caveats:

1. After an IPO, SEC regulations require that insiders cannot sell stock for six months.
2. When insiders sell stock, then others outside the company might ask why this person wants to sell if it represents a good investment. Thus, selling stock can send the wrong signals to the public market and depress the share price. Notice in the example that the shares for the public market did not come from existing shareholders, the intention being to send a strong signal to the market that “this is a valuable stock, and knowing what I know I expect it to rise to much higher value in the future.”

*Stocks of different types move in and out of favor so it is important for the IPO to occur when there is a strong demand for similar stocks.*

### Summary

The example illustrates some of the key points to think about with regard to financing a start-up company, building value, and allocating stock ownership. Points of particular note are:

1. When you make stock allocations, balance the dilution and the corresponding value you are buying. Make projections for several rounds of funding to estimate what will be needed in the future. Founders are often shortsighted in their initial stock grants to employees and give away too much, too early, without a real valuation of the company. Evaluate each dilution in terms of the future value it will bring.
2. Do some soul-searching and ask yourself how much control you need. Can you continue managing and leading your company even if you do not have the majority of voting shares at the board level? Be careful with this issue. A “for profit” business, in most cases, never gives any one person complete control. Even where a business is owned by one person, they are still accountable to customers—there is no absolute control. Can you work with the investors and any new managers who might join the company?
3. Complete all stock negotiations and ownership issues among founders at the outset of the company to avoid any disagreements later on.
4. Make allowance for future stock options to provide incentives for new and existing employees.
5. Focus on increasing the value of the company. Make this the super ordinate goal and have it permeate every employee’s vision of the future of the company. Note that, of necessity, this discussion only considers the “wealth” side of the rewards for starting a company. Other factors (fulfillment, vision, passion, an interest in growing companies) may play an important role in decision-making, but their consideration would make this discussion unnecessarily complex.
6. Business plans usually underestimate the amount of money required to complete product development and get to market. Think carefully about projections. Try to avoid increasing numbers by percentage, but rather think about the constituents of the expenditure or revenue and estimate how much is required.
7. Be realistic in making market penetration/sales growth projections. Use “S” Curves to help think about market ramp up and exploding growth. This is particularly important when thinking about cash flow, which is the “lifeblood” of a start-up business.

*Founders and management must focus on maximizing the value of the company at all stages of its growth.*

### In Conclusion

One of the motivators for founders and employees of a high tech startup is to make significant amounts of money from the appreciation of company share price. To reach this goal, founders and management must focus on maximizing the value of the company at all stages of its growth. Dilution appears at first sight to be a negative effect, but instead should be seen as an investment process in which every time the stock is diluted there is value added to the company.

Stock options to new employees should be based on clear expectations that these new team members will increase the value of the company through their contribution. Taking additional investment or granting stock for strategic partnerships should be viewed through the “lens of added value.” To help with the decision making process, simply ask the question, “If it doesn’t add value, why are we doing it?” This philosophy of adding value can percolate down through all parts of the company to all employees. As owners they can be directly involved in asking questions about how the investment of cash or stock will increase the company value. In their own role in the company they can be asking themselves, “How am I adding value to this company?” which is a far more powerful question than, “Did I do my job today?”

The bottom line is value, and if you are not delivering value, then why are you in business?

### Reference Sources

The Wall Street Dictionary, Robert L. Shook & RJ Shook. New York Institute of Finance.

The American Heritage® Dictionary of the English Language, Third Edition ©1992 by Houghton Mifflin Company. Electronic version licensed from INSO Corporation. All rights reserved.

### Information Sources

[www.myStockOptions.com](http://www.myStockOptions.com): A web site for people who have stock options; provides information and calculation tools.

[www.edgar-online.com/ipoexpress](http://www.edgar-online.com/ipoexpress): Part of the EDGAR reporting system which gives information on IPOs.

*The bottom line is value, and if you are not delivering value, then why are you in business?*

### Glossary of Terms

**Authorized Stock:** The maximum amount of stock a corporation may issue. The fixed amount is stated in the company's certificate of incorporation.

**Face Value:** The amount of money for which a share can be redeemed in cash.

**First Round Funding:** The first major investment in a company; usually follows the seed round. Used for initial development.

**IPO:** Initial Public Offering

**Issued Stock:** The total number of a company's publicly held stock shares plus the number of shares the company holds as treasury stock.

**Market Capitalization:** A company's worth as indicated by the price of its outstanding shares of stock.

**Mezzanine Round:** A pre-IPO round of funding. The stage of a company's development just prior to its going public, in venture capital language. Venture capitalists entering at that point have a lower risk of loss than at previous stages and can look forward to early capital appreciation as a result of the market value gained by an initial public offering.

**Outstanding Stock:** All of a company's ownership shares of stock that have been publicly purchased or that are owned by the company's officers/employees. Shares that the company has repurchased are considered outstanding stock.

**Par Value:** A stock certificate's face value.

**Preferred Stock:** Stock shares that represent a portion of ownership in a company. These shares normally carry fixed dividends and claims. In start-up companies with VC investments, it is the claims which are important. Preferred shares are usually purchased at a much higher price than common shares and carry rights intended to help protect the preferred shareholder. The ratio of the price between common and preferred can be a complex issue with income tax implications and is beyond the scope of this paper.

**Second Round Funding:** The investment made after the first round. Often used to complete development and begin marketing a product. In many situations this round precedes an IPO or Mezzanine Round.

**Seed Round:** The first money put into a new business venture, usually directly from the founders or a loan.

**Share:** A single stock unit that represents a portion of company ownership.

**Stock:** A unit of company ownership.

**Stock Split:** Occurs when stock shares are divided into a smaller or larger number of stock shares. As an example, a company may issue a two for one split in which every shareholder would receive two shares for every share they turned in, and the par value of a share would be halved. When the number of shares is reduced, this is called a reverse split.

**Treasury Stock:** Stock a company issues and then buys back, at which time it is placed in the company's treasury where it earns no dividends and carries no voting privileges. It is included in the count of "Issued Stock."

**Underwriting:** Investment Bankers assume the risk of buying new issues of securities from a corporation and distributing them to the public. Underwriters profit from the difference between the purchase and selling price.

**Vesting:** Rights an employee receives for working at a company a specified length of time. The rights normally include such things as pension payments, participation in stock plans, and profit sharing. The term is often associated with the period that it takes for an employee or founder to have the right to own the shares they have been granted. As an example, an investor may want to keep a founder working at a company for a certain period, say four years. To accomplish this, the investor might insist that as part of funding, the founder would become entitled to 25 percent of their shares every year, thus it takes four years to own the stock. Sometimes this can be done retroactively; that is, even if the founder put up the seed money and owns the stock, there can still be a period of “re-vesting.” This process is often referred to as “Golden Handcuffs.” For employees, the same process is often applied; their stock options might vest over a number of years.

The authors wish to thank the many people who reviewed and commented on this paper. Their contributions certainly improved the quality and substance of the material; however, any mistakes or errors are due solely to the authors.

This white paper is distributed by Berger Lewis Accountancy Corporation.

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**COMPANY VALUE DRIVES THE VALUE OF FOUNDERS' STOCK - A White Paper**

CAP TABLE RECAP Rev. Date: 3/8/2012  
 Presented at: INVESTOR ACADEMY-TERM SHEETS

	Founders Table 1			As of Option Pool Inclusion Table 2			As of Preferred A inclusion Table 4			As of Preferred B inclusion Table 5			As of Investors Group inclusion Table 6		
	\$	%	Shares	\$	%	Shares	\$	%	Shares	\$	%	Shares	\$	%	Shares
Group 1 Founders	100,000	100.000%	5,000,000	100,000	49.000%	5,000,000	100,000	35.704%	5,000,000	100,000	30.296%	5,000,000	100,000	28.565%	5,000,000
Group 2 Employees	0	0.000%	0	0	0.000%	0	0	12.853%	1,800,000	0	10.906%	1,800,000	0	10.283%	1,800,000
Group 3 Series A Pref'd	0	0.000%	0	10,000,000	51.000%	5,204,082	10,000,000	37.161%	5,204,082	10,000,000	31.532%	5,204,082	10,000,000	29.731%	5,204,082
Group 4 Outside Consultants	0	0.000%	0	0	0.000%	0	0	0.000%	0	0	0.000%	0	0	0.000%	0
Group 5 Bd of Dir. & Adv. Board	0	0.000%	0	0	0.000%	0	0	0.000%	0	0	0.000%	0	0	0.000%	0
Group 6 Series B Pref'd	0	0.000%	0	0	0.000%	0	0	0.000%	0	15,000,000	15.148%	2,500,000	24,000,000	19.995%	3,500,000
Group 7 Option Pool	n/a	0.000%	0	n/a	0.000%	0	n/a	14.282%	2,000,000	n/a	12.118%	2,000,000	n/a	11.426%	2,000,000
<b>Totals</b>	<b>100,000</b>	<b>100.000%</b>	<b>5,000,000</b>	<b>10,100,000</b>	<b>100.000%</b>	<b>10,204,082</b>	<b>10,100,000</b>	<b>100.000%</b>	<b>14,004,082</b>	<b>25,100,000</b>	<b>100.000%</b>	<b>16,504,082</b>	<b>34,100,000</b>	<b>100.000%</b>	<b>17,504,082</b>

**Sub-Schedules:**

Group 1	Founders:	\$\$	Shares	\$\$	Shares	\$\$	Shares	\$\$	Shares	\$\$	Shares
	Founder #1	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000
	Founder #2	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000
	Founder #3	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000
	Founder #4	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000
	Founder #5	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000	20,000	1,000,000
		0	0	0	0	0	0	0	0	0	0
	<b>Total Founders</b>	<b>100,000</b>	<b>5,000,000</b>	<b>100,000</b>	<b>5,000,000</b>	<b>100,000</b>	<b>5,000,000</b>	<b>100,000</b>	<b>5,000,000</b>	<b>100,000</b>	<b>5,000,000</b>

Group 2	Employees:	\$\$	Options/Shs	\$\$	Options/Shs	\$\$	Options/Shs	\$\$	Options/Shs	\$\$	Options/Shs
1	CEO	0	0	0	0	0	800,000	0	800,000	0	800,000
2	CFO	0	0	0	0	0	500,000	0	500,000	0	500,000
3	VP S&M	0	0	0	0	0	500,000	0	500,000	0	500,000
4		0	0	0	0	0	0	0	0	0	0
5		0	0	0	0	0	0	0	0	0	0
6		0	0	0	0	0	0	0	0	0	0
7		0	0	0	0	0	0	0	0	0	0
8		0	0	0	0	0	0	0	0	0	0
9		0	0	0	0	0	0	0	0	0	0
10		0	0	0	0	0	0	0	0	0	0
11		0	0	0	0	0	0	0	0	0	0
12		0	0	0	0	0	0	0	0	0	0
13		0	0	0	0	0	0	0	0	0	0
14		0	0	0	0	0	0	0	0	0	0
15		0	0	0	0	0	0	0	0	0	0
	<b>Total Employees</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>0</b>	<b>1,800,000</b>	<b>0</b>	<b>1,800,000</b>	<b>0</b>	<b>1,800,000</b>

Group 3	Pref'd Stk: Series "A":	\$\$	Shares	\$\$	Shares	\$\$	Shares	\$\$	Shares	\$\$	Shares
	VC #1	0	0	10,000,000	5,204,082	10,000,000	5,204,082	10,000,000	5,204,082	10,000,000	5,204,082
		0	0	0	0	0	0	0	0	0	0
		0	0	0	0	0	0	0	0	0	0
		0	0	0	0	0	0	0	0	0	0
	<b>Total Series A Pref'd</b>	<b>0</b>	<b>0</b>	<b>10,000,000</b>	<b>5,204,082</b>	<b>10,000,000</b>	<b>5,204,082</b>	<b>10,000,000</b>	<b>5,204,082</b>	<b>10,000,000</b>	<b>5,204,082</b>

**COMPANY VALUE DRIVES THE VALUE OF FOUNDERS' STOCK - A White Paper**

CAP TABLE RECAP Rev. Date: 3/8/2012  
Presented at: **INVESTOR ACADEMY-TERM SHEETS**

	Founders Table 1		As of Option Pool Inclusion Table 2		As of Preferred A inclusion Table 4		As of Preferred B inclusion Table 5		As of Investors Group inclusion Table 6	
	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares
Group 4	<b>Outside Consultants:</b>									
	\$	Options/Sh	\$	Options/Sh	\$	Options/Sh	\$	Options/Sh	\$	Options/Sh
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
	<b>Total Consultants</b>									

	Founders Table 1		As of Option Pool Inclusion Table 2		As of Preferred A inclusion Table 4		As of Preferred B inclusion Table 5		As of Investors Group inclusion Table 6	
	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares
Group 5	<b>Board and Advisory Board</b>									
	\$	Shares	\$	Shares	\$	Shares	\$	Shares	\$	Shares
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	0	0	0	0	0	0	0	0	0	0
	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
	<b>Total Board &amp; Adv. Board</b>									

	Founders Table 1		As of Option Pool Inclusion Table 2		As of Preferred A inclusion Table 4		As of Preferred B inclusion Table 5		As of Investors Group inclusion Table 6	
	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares
Group 6	<b>Pref'd Stk:</b>									
	<b>Series "B" :</b>									
	\$	Shares	\$	Shares	\$	Shares	\$	Shares	\$	Shares
	0	0	0	0	0	0	15,000,000	2,500,000	15,000,000	2,500,000
	0	0	0	0	0	0	0	9,000,000	1,000,000	
	0	0	0	0	0	0	0	0	0	
	0	0	0	0	0	0	0	0	0	
	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>15,000,000</u>	<u>2,500,000</u>	<u>24,000,000</u>	<u>3,500,000</u>
	<b>Total Series B Pref'd</b>									

	Founders Table 1		As of Option Pool Inclusion Table 2		As of Preferred A inclusion Table 4		As of Preferred B inclusion Table 5		As of Investors Group inclusion Table 6	
	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares	\$	% Shares
Group 7	<b>Option Pool:</b>									
	\$	Options/Sh	\$	Options/Sh	\$	Options/Sh	\$	Options/Sh	\$	Options/Sh
		0	0	0	0	3,800,000	0	3,800,000	0	3,800,000
		0	0	0	0	0	0	0	0	0
		0	0	0	0	0	0	0	0	0
		0	0	0	0	(1,800,000)	(1,800,000)	(1,800,000)	(1,800,000)	
		0	0	0	0	0	0	0	0	
		0	0	0	0	0	0	0	0	
	<u>n/a</u>	<u>0</u>	<u>n/a</u>	<u>0</u>	<u>n/a</u>	<u>2,000,000</u>	<u>n/a</u>	<u>2,000,000</u>	<u>n/a</u>	<u>2,000,000</u>
	<b>Total Option Pool Available</b>									

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**Due Diligence Handbook Appendices**

**Items For Consideration**



# Appendix U - National Venture Capital Association Sample Documents (as of NVCA's Review in May, 2012)

The following sample documents, as provided by the National Venture Capital Association, are included to provide samples as a reference point. Some of these documents are not specifically related to a financing, but may end up being modified as part of a financing (for example, a new financing may require amending the Articles of Incorporation).

**Please note two important things:**

- 1) These are samples for illustrative purposes to help new members familiarize themselves with what these types of documents look like before they encounter them in a financing. They should NOT be used in any specific transaction.
- 2) These documents are examples of documents used in the United States.

<b>Term Sheet</b>	<b>28</b>
<b>Stock Purchase Agreement</b>	<b>29</b>
<b>Certificate of Incorporation</b>	<b>30</b>
<b>Investor Rights Agreement</b>	<b>31</b>
<b>Voting Agreement</b>	<b>32</b>
<b>Right of First Refusal and Co-Sal Agreement</b>	<b>32</b>
<b>Management Rights Letter</b>	<b>32</b>
<b>Indemnification Agreement</b>	<b>32</b>
<b>Model Legal Agreement</b>	<b>32</b>

Updated versions of these sample documents are available for download in Microsoft Word format at the NVCA's website at:

[http://www.nvca.org/index.php?option=com\\_content&view=article&id=108&Itemid=136](http://www.nvca.org/index.php?option=com_content&view=article&id=108&Itemid=136).

## **Important Disclaimer:**

By including these samples as part of the Appendices to this Due Diligence Handbook, we are NOT encouraging their use, or the use of their provisions. This Handbook and its appendices do not constitute legal advice or counsel, and neither Keiretsu Forum nor the authors of this Handbook are providing any legal advice as to the use or applicability of these terms. We are just including samples for illustration of how the terms discussed in the earlier Appendix can be incorporated into full documents and as samples of the types of documents that investors may see in use in reviewing materials provided by presenting companies and their attorneys. Please do not provide these terms or documents to presenting companies for their use or your own use in either negotiating or completing transactions with them.

## General Information, as relayed on and quoted directly from the NVCA's Website

The following documents are a "template" set of model legal documents for venture capital investments put together by a group of leading venture capital attorneys.

All of the above model legal docs were reviewed in May of 2012 and updates were made accordingly.

In general, these documents are intended to reflect current practices and customs, and we have attempted to note where the West Coast and East Coast differ in a number of their practices. However, one of our goals in drafting these documents is also to reflect "best practices" and avoid hidden legal traps, even if doing so means straying from current custom and practice. We have attempted to avoid, or at least point out, certain problematic provisions that have become "market standard" terms. We have generally tried to indicate such issues with a footnote and explanatory language.

- The model documents aim to:
- reflect and in a number of instances, guide and establish industry norms
- be fair, avoid bias toward the VC or the company/entrepreneur
- present a range of potential options, reflecting a variety of financing terms
- include explanatory commentary where necessary or helpful
- anticipate and eliminate traps for the unwary (e.g., unenforceable or unworkable provisions)
- provide a comprehensive set of internally consistent financing documents
- promote consistency among transactions
- reduce transaction costs and time

***DISCLAIMER: EACH DOCUMENT IS INTENDED TO SERVE AS A STARTING POINT ONLY, AND SHOULD BE TAILORED TO MEET YOUR SPECIFIC REQUIREMENTS. THE DOCUMENTS SHOULD NOT BE CONSTRUED AS LEGAL ADVICE FOR ANY PARTICULAR FACTS OR CIRCUMSTANCES.***

**This sample document is the work product of a national coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample document presents an array of (often mutually exclusive) options with respect to particular deal provisions.**

## **TERM SHEET**

### ***Preliminary Note***

*This term sheet maps to the NVCA Model Documents, and for convenience the provisions are grouped according to the particular Model Document in which they may be found. Although this term sheet is perhaps somewhat longer than a "typical" VC Term Sheet, the aim is to provide a level of detail that makes the term sheet useful as both a road map for the document drafters and as a reference source for the business people to quickly find deal terms without the necessity of having to consult the legal documents (assuming of course there have been no changes to the material deal terms prior to execution of the final documents).*

**TERM SHEET**  
**FOR SERIES A PREFERRED STOCK FINANCING OF**  
**[INSERT COMPANY NAME], INC.**  
[\_\_\_\_\_, 20\_\_]

This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [\_\_\_\_\_] Inc., a [Delaware] corporation (the “**Company**”). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality [and Counsel and Expenses] provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest, and is conditioned on the completion of due diligence, legal review and documentation that is satisfactory to the Investors. This Term Sheet shall be governed in all respects by the laws of the [State of Delaware].

**Offering Terms**

*Closing Date:* As soon as practicable following the Company’s acceptance of this Term Sheet and satisfaction of the Conditions to Closing (the “**Closing**”). [provide for multiple closings if applicable]

*Investors:* Investor No. 1: [\_\_\_\_\_] shares ([\_]%), \$[\_\_\_\_\_]  
Investor No. 2: [\_\_\_\_\_] shares ([\_]%), \$[\_\_\_\_\_]  
[as well other investors mutually agreed upon by Investors and the Company]

*Amount Raised:* \$[\_\_\_\_\_], [including \$[\_\_\_\_\_]] from the conversion of principal [and interest] on bridge notes.<sup>1</sup>

*Price Per Share:* \$[\_\_\_\_\_] per share (based on the capitalization of the Company set forth below) (the “**Original Purchase Price**”).

*Pre-Money Valuation:* The Original Purchase Price is based upon a fully-diluted pre-money valuation of \$[\_\_\_\_\_] and a fully-diluted post-money valuation of \$[\_\_\_\_\_] (including an employee pool representing [\_] % of the fully-diluted post-money capitalization).

*Capitalization:* The Company’s capital structure before and after the Closing is set forth on Exhibit A.

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<sup>1</sup> Modify this provision to account for staged investments or investments dependent on the achievement of milestones by the Company.

## CHARTER<sup>2</sup>

### *Dividends:*

[*Alternative 1:* Dividends will be paid on the Series A Preferred on an as-converted basis when, as, and if paid on the Common Stock]

[*Alternative 2:* The Series A Preferred will carry an annual [ ]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.]<sup>3</sup>

[*Alternative 3:* Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to \$[ ] per share of Series A Preferred when and if declared by the Board.]

### *Liquidation Preference:*

In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

[*Alternative 1 (non-participating Preferred Stock):* First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. The balance of any proceeds shall be distributed pro rata to holders of Common Stock.]

[*Alternative 2 (full participating Preferred Stock):* First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis.]

[*Alternative 3 (cap on Preferred Stock participation rights):* First pay [one] times the Original Purchase Price [plus accrued dividends] [plus declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [ ] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).]

A merger or consolidation (other than one in which stockholders of

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<sup>2</sup> The Charter (Certificate of Incorporation) is a public document, filed with the Secretary of State of the state in which the company is incorporated, that establishes all of the rights, preferences, privileges and restrictions of the Preferred Stock.

<sup>3</sup> In some cases, accrued and unpaid dividends are payable on conversion as well as upon a liquidation event. Most typically, however, dividends are not paid if the preferred is converted. Another alternative is to give the Company the option to pay accrued and unpaid dividends in cash or in common shares valued at fair market value. The latter are referred to as "PIK" (payment-in-kind) dividends.

the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a “**Deemed Liquidation Event**”), thereby triggering payment of the liquidation preferences described above [unless the holders of [ ]% of the Series A Preferred elect otherwise]. [The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to escrow in connection with a Deemed Liquidation Event.]<sup>4</sup>

*Voting Rights:*

The Series A Preferred shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) [so long as [insert fixed number, or %, or “any”] shares of Series A Preferred are outstanding,] the Series A Preferred as a class shall be entitled to elect [ ] [ ] members of the Board (the “**Series A Directors**”), and (ii) as required by law. The Company’s Certificate of Incorporation will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock.<sup>5</sup>

*Protective Provisions:*

[So long as [insert fixed number, or %, or “any”] shares of Series A Preferred are outstanding,] in addition to any other vote or approval required under the Company’s Charter or By-laws, the Company will not, without the written consent of the holders of at least [ ]% of the Company’s Series A Preferred, either directly or by amendment, merger, consolidation, or otherwise:

- (i) liquidate, dissolve or wind-up the affairs of the Company, or effect any merger or consolidation or any other Deemed Liquidation Event;
- (ii) amend, alter, or repeal any provision of the Certificate of Incorporation or Bylaws [in a manner adverse to the Series A Preferred];<sup>6</sup>
- (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security, having rights, preferences or privileges senior to or on parity with the Series A Preferred, or increase the

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<sup>4</sup> See Subsection 2.3.4 of the Model Certificate of Incorporation and the detailed explanation in related footnote 25.

<sup>5</sup> For corporations incorporated in California, one cannot “opt out” of the statutory requirement of a separate class vote by Common Stockholders to authorize shares of Common Stock. The purpose of this provision is to “opt out” of DGL 242(b)(2).

<sup>6</sup> Note that as a matter of background law, Section 242(b)(2) of the Delaware General Corporation Law provides that if any proposed charter amendment would adversely alter the rights, preferences and powers of one series of Preferred Stock, but not similarly adversely alter the entire class of all Preferred Stock, then the holders of that series are entitled to a separate series vote on the amendment.



authorized number of shares of Series A Preferred; (iv) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, [other than stock repurchased from former employees or consultants in connection with the cessation of their employment/services, at the lower of fair market value or cost;] [other than as approved by the Board, including the approval of [\_\_\_\_\_] Series A Director(s)]; or (v) create or authorize the creation of any debt security [if the Company's aggregate indebtedness would exceed \$[\_\_\_\_\_] [other than equipment leases or bank lines of credit] [unless such debt security has received the prior approval of the Board of Directors, including the approval of [\_\_\_\_\_] Series A Director(s)]; (vi) create or hold capital stock in any subsidiary that is not a wholly-owned subsidiary or dispose of any subsidiary stock or all or substantially all of any subsidiary assets; [or (vii) increase or decrease the size of the Board of Directors].<sup>7</sup>

*Optional Conversion:*

The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under "Anti-dilution Provisions."

*Anti-dilution Provisions:*

In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula:

[*Alternative 1:* "Typical" weighted average:

$$CP_2 = CP_1 * (A+B) / (A+C)$$

CP<sub>2</sub> = Series A Conversion Price in effect immediately after new issue

CP<sub>1</sub> = Series A Conversion Price in effect immediately prior to new issue

A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)<sup>8</sup>

B = Aggregate consideration received by the Corporation

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<sup>7</sup> The board size provision may also be addressed in the Voting Agreement; see Section 1.1 of the Model Voting Agreement.

<sup>8</sup> The "broadest" base would include shares reserved in the option pool.

with respect to the new issue divided by CP<sub>1</sub>  
C = Number of shares of stock issued in the subject transaction]

[*Alternative 2*: Full-ratchet – the conversion price will be reduced to the price at which the new shares are issued.]

[*Alternative 3*: No price-based anti-dilution protection.]

The following issuances shall not trigger anti-dilution adjustment:<sup>9</sup>

(i) securities issuable upon conversion of any of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; and (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [ ] Series A Director(s)].

*Mandatory Conversion:*

Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a [firm commitment] underwritten public offering with a price of [ ] times the Original Purchase Price (subject to adjustments for stock dividends, splits, combinations and similar events) and [net/gross] proceeds to the Company of not less than \$[ ] (a "QPO"), or (ii) upon the written consent of the holders of [ ]% of the Series A Preferred.<sup>10</sup>

*[Pay-to-Play:*

[Unless the holders of [ ]% of the Series A elect otherwise,] on any subsequent [down] round all [Major] Investors are required to purchase their pro rata share of the securities set aside by the Board for purchase by the [Major] Investors. All shares of Series A Preferred<sup>11</sup> of any [Major] Investor failing to do so will automatically [lose anti-dilution rights] [lose right to participate in future rounds] [convert to Common Stock and lose the right to a

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<sup>9</sup> Note that additional exclusions are frequently negotiated, such as issuances in connection with equipment leasing and commercial borrowing. See Subsections 4.4.1(d)(v)-(viii) of the Model Certificate of Incorporation for additional exclusions.

<sup>10</sup> The per share test ensures that the investor achieves a significant return on investment before the Company can go public. Also consider allowing a non-QPO to become a QPO if an adjustment is made to the Conversion Price for the benefit of the investor, so that the investor does not have the power to block a public offering.

<sup>11</sup> Alternatively, this provision could apply on a proportionate basis (e.g., if Investor plays for ½ of pro rata share, receives ½ of anti-dilution adjustment).

Board seat if applicable].<sup>12</sup>

*Redemption Rights:*<sup>13</sup>

Unless prohibited by Delaware law governing distributions to stockholders, the Series A Preferred shall be redeemable at the option of holders of at least [ ]% of the Series A Preferred commencing any time after [ ] at a price equal to the Original Purchase Price [plus all accrued but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt-out)].<sup>14</sup>

### **STOCK PURCHASE AGREEMENT**

*Representations and Warranties:* Standard representations and warranties by the Company. [Representations and warranties by Founders regarding [technology ownership, etc.]].<sup>15</sup>

*Conditions to Closing:* Standard conditions to Closing, which shall include, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and

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<sup>12</sup> If the punishment for failure to participate is losing some but not all rights of the Preferred (e.g., anything other than a forced conversion to common), the Certificate of Incorporation will need to have so-called “blank check preferred” provisions at least to the extent necessary to enable the Board to issue a “shadow” class of preferred with diminished rights in the event an investor fails to participate. Because these provisions flow through the charter, an alternative Model Certificate of Incorporation with “pay-to-play lite” provisions (e.g., shadow Preferred) has been posted. As a drafting matter, it is far easier to simply have (some or all of) the preferred convert to common.

<sup>13</sup> Redemption rights allow Investors to force the Company to redeem their shares at cost (and sometimes investors may also request a small guaranteed rate of return, in the form of a dividend). In practice, redemption rights are not often used; however, they do provide a form of exit and some possible leverage over the Company. While it is possible that the right to receive dividends on redemption could give rise to a Code Section 305 “deemed dividend” problem, many tax practitioners take the view that if the liquidation preference provisions in the Charter are drafted to provide that, on conversion, the holder receives the greater of its liquidation preference or its as-converted amount (as provided in the Model Certificate of Incorporation), then there is no Section 305 issue.

<sup>14</sup> Due to statutory restrictions, the Company may not be legally permitted to redeem in the very circumstances where investors most want it (the so-called “sideways situation”). Accordingly, and particularly in light of the Delaware Chancery Court’s ruling in *Thoughtworks* (see discussion in Model Charter), investors may seek enforcement provisions to give their redemption rights more teeth - - e.g., the redemption amount shall be paid in the form of a one-year note to each unredeemed holder of Series A Preferred, and the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company’s Board of Directors until such amounts are paid in full.

<sup>15</sup> Founders’ representations are controversial and may elicit significant resistance as they are found in a minority of venture deals. They are more likely to appear if Founders are receiving liquidity from the transaction, or if there is heightened concern over intellectual property (e.g., the Company is a spin-out from an academic institution or the Founder was formerly with another company whose business could be deemed competitive with the Company), or in international deals. Founders’ representations are even less common in subsequent rounds, where risk is viewed as significantly diminished and fairly shared by the investors, rather than being disproportionately borne by the Founders. A sample set of Founders Representations is attached as an Addendum at the end of the Model Stock Purchase Agreement.

preferences of the Series A Preferred, and an opinion of counsel to the Company.

*Counsel and Expenses:*

[Investor/Company] counsel to draft closing documents. Company to pay all legal and administrative costs of the financing [at Closing], including reasonable fees (not to exceed \$[\_\_\_\_]) and expenses of Investor counsel[, unless the transaction is not completed because the Investors withdraw their commitment without cause].<sup>16</sup>

Company Counsel: [\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_]

Investor Counsel: [\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_]

**INVESTORS' RIGHTS AGREEMENT**

*Registration Rights:*

*Registrable Securities:*

All shares of Common Stock issuable upon conversion of the Series A Preferred [and {any other Common Stock held by the Investors}] will be deemed "**Registrable Securities.**"<sup>17</sup>

*Demand Registration:*

Upon earliest of (i) [three-five] years after the Closing; or (ii) [six] months<sup>18</sup> following an initial public offering ("IPO"), persons holding [\_\_]% of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than \$[5-15] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).

*Registration on Form S-3:*

The holders of [10-30]% of the Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities for an aggregate

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<sup>16</sup> The bracketed text should be deleted if this section is not designated in the introductory paragraph as one of the sections that is binding upon the Company regardless of whether the financing is consummated.

<sup>17</sup> Note that Founders/management sometimes also seek limited registration rights.

<sup>18</sup> The Company will want the percentage to be high enough so that a significant portion of the investor base is behind the demand. Companies will typically resist allowing a single investor to cause a registration. Experienced investors will want to ensure that less experienced investors do not have the right to cause a demand registration. In some cases, different series of Preferred Stock may request the right for that series to initiate a certain number of demand registrations. Companies will typically resist this due to the cost and diversion of management resources when multiple constituencies have this right.

offering price of at least \$[1-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [two] per year.

*Piggyback Registration:*

The holders of Registrable Securities will be entitled to “piggyback” registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [20-30]% on a pro rata basis and to complete reduction on an IPO at the underwriter’s discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders’ shares are reduced.

*Expenses:*

The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions will be borne by the Company. The Company will also pay the reasonable fees and expenses[, not to exceed \$\_\_\_\_\_,] of one special counsel to represent all the participating stockholders.

*Lock-up:*

Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company [(including/excluding shares acquired in or following the IPO)] for a period of up to 180 days [plus up to an additional 18 days to the extent necessary to comply with applicable regulatory requirements]<sup>19</sup> following the IPO (provided all directors and officers of the Company [and [1 – 5]% stockholders] agree to the same lock-up). [Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to Investors, pro rata, based on the number of shares held.

*Termination:*

Upon a Deemed Liquidation Event, [and/or] when all shares of an Investor are eligible to be sold without restriction under Rule 144 [and/or] the [\_\_\_\_] anniversary of the IPO.

No future registration rights may be granted without consent of the holders of a [majority] of the Registrable Securities unless subordinate to the Investor’s rights.

*Management and Information Rights:*

A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requests one.<sup>20</sup>

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<sup>19</sup> See commentary in footnotes 23 and 24 of the Model Investors’ Rights Agreement regarding possible extensions of lock-up period.

<sup>20</sup> See commentary in introduction to Model Managements Rights Letter, explaining purpose of such letter.

Any [Major] Investor [(who is not a competitor)] will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such Major Investor (i) annual, quarterly, [and monthly] financial statements, and other information as determined by the Board; (ii) thirty days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year[; and (iii) promptly following the end of each quarter an up-to-date capitalization table. A "Major Investor" means any Investor who purchases at least \$[\_\_\_\_\_] of Series A Preferred.

*Right to Participate Pro Rata in Future Rounds:*

All [Major] Investors shall have a pro rata right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet. In addition, should any [Major] Investor choose not to purchase its full pro rata share, the remaining [Major] Investors shall have the right to purchase the remaining pro rata shares.

*Matters Requiring Investor Director Approval:*

[So long as the holders of Series A Preferred are entitled to elect a Series A Director, the Company will not, without Board approval, which approval must include the affirmative vote of [one/both] of the Series A Director(s):

- (i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company;
- (ii) make any loan or advance to any person, including, any employee or director, except advances and similar expenditures in the ordinary course of business or under the terms of a employee stock or option plan approved by the Board of Directors;
- (iii) guarantee, any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business;
- (iv) make any investment inconsistent with any investment policy approved by the Board;
- (v) incur any aggregate indebtedness in excess of \$[\_\_\_\_\_] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business;
- (vi) enter into or be a party to any transaction with any director, officer or employee of the Company or any "associate" (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such person [except transactions resulting in payments to or by the Company in an amount less than \$[60,000] per year], [or transactions made

in the ordinary course of business and pursuant to reasonable requirements of the Company's business and upon fair and reasonable terms that are approved by a majority of the Board of Directors];<sup>21</sup> (vii) hire, fire, or change the compensation of the executive officers, including approving any option grants; (viii) change the principal business of the Company, enter new lines of business, or exit the current line of business; (ix) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (x) enter into any corporate strategic relationship involving the payment contribution or assignment by the Company or to the Company of assets greater than [\$100,000.00].

*Non-Competition and  
Non-Solicitation Agreements:*<sup>22</sup>

Each Founder and key employee will enter into a [one] year non-competition and non-solicitation agreement in a form reasonably acceptable to the Investors.

*Non-Disclosure and  
Developments Agreement:*

Each current and former Founder, employee and consultant will enter into a non-disclosure and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.

*Board Matters:*

[Each Board Committee shall include at least one Series A Director.]

The Board of Directors shall meet at least [monthly][quarterly], unless otherwise agreed by a vote of the majority of Directors.

The Company will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors. Company to enter into Indemnification Agreement with each Series A Director [and affiliated funds] in form acceptable to such director. In the event the Company merges with another entity and is not the surviving corporation, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume the Company's obligations with respect to indemnification of Directors.

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<sup>21</sup> Note that Section 402 of the Sarbanes-Oxley Act of 2003 would require repayment of any loans in full prior to the Company filing a registration statement for an IPO.

<sup>22</sup> Note that non-compete restrictions (other than in connection with the sale of a business) are prohibited in California, and may not be enforceable in other jurisdictions, as well. In addition, some investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a Non-Compete/Non-Solicit (and indeed the agreement may arguably be invalid absent such additional consideration - - although having an employee sign a non-compete contemporaneous with hiring constitutes adequate consideration in jurisdictions where non-competes are generally enforceable). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Non-competes typically have a one year duration, although state law may permit up to two years.

*Employee Stock Options:* All employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months].

[Immediately prior to the Series A Preferred Stock investment, [ ] shares will be added to the option pool creating an unallocated option pool of [ ] shares.]

*Key Person Insurance:* Company to acquire life insurance on Founders [*name each Founder*] in an amount satisfactory to the Board. Proceeds payable to the Company.

### **RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT**

*Right of first Refusal/  
Right of Co-Sale  
(Take-me-Along):* Company first and Investors second (to the extent assigned by the Board of Directors,) will have a right of first refusal with respect to any shares of capital stock of the Company proposed to be transferred by Founders [and future employees holding greater than [1]% of Company Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)], with a right of oversubscription for Investors of shares unsubscribed by the other Investors. Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the amount of securities held by the seller and those held by the participating Investors.<sup>23</sup>

### **VOTING AGREEMENT**

*Board of Directors:* At the initial Closing, the Board shall consist of [ ] members comprised of (i) [*Name*] as [the representative designated by [ ]], as the lead Investor, (ii) [*Name*] as the representative designated by the remaining Investors, (iii) [*Name*] as the representative designated by the Founders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [ ] person(s) who are not employed by the Company and who are mutually acceptable [to the Founders and Investors][to the other directors].

*[DragAlong]:* Holders of Preferred Stock and the Founders [and all future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options)] shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by [the Board of Directors] [and the holders of

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<sup>23</sup> Certain exceptions are typically negotiated, e.g., estate planning or *de minimis* transfers. Investors may also seek ROFR rights with respect to transfers by investors, in order to be able to have some control over the composition of the investor group.



\_\_\_\_% of the outstanding shares of Preferred Stock, on an as-converted basis (the “**Electing Holders**”), so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder's pro rata portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Certificate of Incorporation.]<sup>24</sup>

*[Sale Rights:*

Upon written notice to the Company from the Electing Holders, the Company shall initiate a process intended to result in a sale of the Company.]<sup>25</sup>

### OTHER MATTERS

*Founders' Stock:*

All Founders to own stock outright subject to Company right to buyback at cost. Buyback right for [ ]% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [ ] months.

*[Existing Preferred Stock:]<sup>26</sup>*

The terms set forth above for the Series [ ] Preferred Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing Preferred Stock to this term sheet will be made at the Closing.]

*No Shop/Confidentiality:*

The Company agrees to work in good faith expeditiously towards a closing. The Company and the Founders agree that they will not, for a period of [ ] weeks from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. [In the event that the Company breaches this no-shop obligation and, prior to [ ], closes any of the above-referenced transactions [without providing the Investors the opportunity to invest on the same terms as the other parties to such transaction], then the Company shall pay to the Investors \$[ ] upon the closing of any such transaction as liquidated

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<sup>24</sup> See Subsection 3.3 of the Model Voting Agreement for a more detailed list of conditions that must be satisfied in order for the drag-along to be invoked.

<sup>25</sup> See Addendum to Model Voting Agreement

<sup>26</sup> Necessary only if this is a later round of financing, and not the initial Series A round.

damages.]<sup>27</sup> The Company will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [\_\_\_\_], as lead Investor, without the written consent of the Investors.

*Expiration:*

This Term Sheet expires on [\_\_\_\_ \_\_, 20\_\_] if not accepted by the Company by that date.

EXECUTED THIS [\_\_] DAY OF [\_\_\_\_], 20[\_\_].

[SIGNATURE BLOCKS]

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<sup>27</sup> It is unusual to provide for such "break-up" fees in connection with a venture capital financing, but might be something to consider where there is a substantial possibility the Company may be sold prior to consummation of the financing (e.g., a later stage deal).

EXHIBIT A

Pre and Post-Financing Capitalization

Security	Pre-Financing		Post-Financing	
	# of Shares	%	# of Shares	%
Common – Founders				
Common – Employee Stock Pool				
Issued				
Unissued				
[Common – Warrants]				
Series A Preferred				
Total				

**SERIES A PREFERRED STOCK PURCHASE AGREEMENT**

## ***Preliminary Note***

*The Stock Purchase Agreement sets forth the basic terms of the purchase and sale of the preferred stock to the investors (such as the purchase price, closing date, conditions to closing) and identifies the other financing documents. Generally this agreement does not set forth either (1) the characteristics of the stock being sold (which are defined in the Certificate of Incorporation) or (2) the relationship among the parties after the closing, such as registration rights, rights of first refusal and co-sale, voting arrangements (these matters often implicate other persons than just the Company and the investors in this round of financing, and are usually embodied in separate agreements to which those others persons are parties, or in some cases by the Certificate of Incorporation). The main items of negotiation in the Stock Purchase Agreement are therefore the price and number of shares being sold, and the representations and warranties that the Company, and sometimes the Founders as well, must make to the investors.*

## TABLE OF CONTENTS

*Note to Drafter: Section headings have been formatted to automatically populate the Table of Contents. However, when editing this document for your own use, the page numbers may change. In order to reflect the correct page numbers in the Table of Contents, you must “update page numbers” to the Table of Contents by (1) right-clicking anywhere in the Table of Contents and (2) choose “update field,” then “update page numbers only.” If you add or delete section headings, follow step (1) and (2) above and choose “update entire table.”*

	<u>Page</u>
1. Purchase and Sale of Preferred Stock .....	1
1.1 Sale and Issuance of Series A Preferred Stock .....	1
1.2 Closing; Delivery .....	1
1.3 Sale of Additional Shares of Preferred Stock .....	2
1.4 [Use of Proceeds .....	3
1.5 Defined Terms Used in this Agreement.....	3
2. Representations and Warranties of the Company .....	5
2.1 Organization, Good Standing, Corporate Power and Qualification .....	6
2.2 Capitalization .....	6
2.3 Subsidiaries .....	8
2.4 Authorization .....	8
2.5 Valid Issuance of Shares.....	9
2.6 Governmental Consents and Filings .....	9
2.7 Litigation.....	9
2.8 Intellectual Property.....	10
2.9 Compliance with Other Instruments .....	11
2.10 Agreements; Actions.....	12
2.11 Certain Transactions .....	13
2.12 Rights of Registration and Voting Rights.....	13
2.13 Property.....	14
2.14 Financial Statements .....	14
2.15 Changes.....	15
2.16 Employee Matters .....	16
2.17 Tax Returns and Payments.....	18
2.18 Insurance .....	18
2.19 Employee Agreements .....	18
2.20 Permits .....	18
2.21 Corporate Documents .....	19
2.22 [83(b) Elections.....	19
2.23 [Real Property Holding Corporation.....	19
2.24 Environmental and Safety Laws .....	19
2.25 [Qualified Small Business Stock .....	20
2.26 Disclosure .....	20
2.27 [Small Business Concern .....	21
2.28 [Foreign Corrupt Practices Act.....	21

TABLE OF CONTENTS  
(continued)

	<u>Page</u>
2.29 [Data Privacy .....	21
3. Representations and Warranties of the Purchasers .....	22
3.1 Authorization .....	22
3.2 Purchase Entirely for Own Account .....	22
3.3 Disclosure of Information .....	23
3.4 Restricted Securities.....	23
3.5 No Public Market.....	23
3.6 Legends .....	23
3.7 Accredited Investor .....	24
3.8 Foreign Investors .....	24
3.9 No General Solicitation.....	24
3.10 Exculpation Among Purchasers .....	24
3.11 Residence .....	25
3.12 [Consent to Promissory Note Conversion and Termination.....	25
4. Conditions to the Purchasers' Obligations at Closing .....	25
4.1 Representations and Warranties.....	26
4.2 Performance .....	26
4.3 Compliance Certificate .....	26
4.4 Qualifications.....	26
4.5 Opinion of Company Counsel .....	26
4.6 Board of Directors.....	26
4.7 Indemnification Agreement .....	26
4.8 Investors' Rights Agreement .....	26
4.9 Right of First Refusal and Co-Sale Agreement .....	26
4.10 Voting Agreement.....	26
4.11 Restated Certificate.....	27
4.12 Secretary's Certificate.....	27
4.13 Proceedings and Documents .....	27
4.14 Minimum Number of Shares at Initial Closing.....	27
4.15 Management Rights .....	27
4.16 [SBA Matters .....	27
4.17 [Preemptive Rights.....	27
5. Conditions of the Company's Obligations at Closing .....	27
5.1 Representations and Warranties.....	28
5.2 Performance .....	28
5.3 Qualifications.....	28
5.4 Investors' Rights Agreement .....	28
5.5 Right of First Refusal and Co-Sale Agreement .....	28
5.6 Voting Agreement.....	28
5.7 [Minimum Number of Shares at Initial Closing.....	28
6. Miscellaneous .....	28

TABLE OF CONTENTS  
(continued)

	<u>Page</u>
6.1 Survival of Warranties .....	28
6.2 Successors and Assigns.....	28
6.3 Governing Law .....	29
6.4 Counterparts.....	29
6.5 Titles and Subtitles.....	29
6.6 Notices .....	29
6.7 No Finder’s Fees.....	29
6.8 Fees and Expenses .....	30
6.9 [Attorneys’ Fees.....	30
6.10 Amendments and Waivers .....	30
6.11 Severability .....	30
6.12 Delays or Omissions .....	30
6.13 Entire Agreement.....	31
6.14 [Corporate Securities Law .....	31
6.15 Dispute Resolution.....	31
6.16 [No Commitment for Additional Financing .....	32
6.17 [Waiver of Conflicts .....	33

Exhibit A - SCHEDULE OF PURCHASERS

Exhibit B - FORM OF AMENDED AND RESTATED  
CERTIFICATE OF INCORPORATION

Exhibit C - DISCLOSURE SCHEDULE

Exhibit D - FORM OF INDEMNIFICATION AGREEMENT

Exhibit E - FORM OF INVESTORS’ RIGHTS AGREEMENT

Exhibit F - FORM OF MANAGEMENT RIGHTS LETTER

Exhibit G - FORM OF RIGHT OF FIRST REFUSAL AND CO-SALE  
AGREEMENT

Exhibit H - FORM OF VOTING AGREEMENT

Exhibit I - FORM OF LEGAL OPINION OF [COMPANY COUNSEL]

[Exhibit J - MILESTONE EVENTS]

ADDENDUM TO STOCK PURCHASE AGREEMENT: SAMPLE FOUNDER  
REPRESENTATIONS AND WARRANTIES



## SERIES A PREFERRED STOCK PURCHASE AGREEMENT

THIS SERIES A PREFERRED STOCK PURCHASE AGREEMENT is made as of the [ ] day of [ ], 20\_ by and among [ ], a Delaware corporation (the “**Company**”), the investors listed on Exhibit A attached to this Agreement (each a “**Purchaser**” and together the “**Purchasers**”) [and the persons listed as “**Founders**” on the signature pages to this Agreement (each a “**Founder**” and together the “**Founders**”)].

The parties hereby agree as follows:

1. Purchase and Sale of Preferred Stock.

1.1 Sale and Issuance of Series A Preferred Stock.

(a) The Company shall adopt and file with the Secretary of State of the State of Delaware on or before the Initial Closing<sup>1</sup> (as defined below) the Amended and Restated Certificate of Incorporation in the form of Exhibit B attached to this Agreement (the “**Restated Certificate**”).<sup>2</sup>

(b) Subject to the terms and conditions of this Agreement, each Purchaser agrees to purchase at the Closing and the Company agrees to sell and issue to each Purchaser at the Closing that number of shares of Series A Preferred Stock, \$ [ ] par value per share (the “**Series A Preferred Stock**”), set forth opposite each Purchaser’s name on Exhibit A, at a purchase price of \$[ ] per share. The shares of Series A Preferred Stock issued to the Purchasers pursuant to this Agreement (including any shares issued at the Initial Closing and any [Milestone Shares or] Additional Shares, as defined below) shall be referred to in this Agreement as the “**Shares**.”

1.2 Closing; Delivery.

(a) The initial purchase and sale of the Shares shall take place remotely via the exchange of documents and signatures, at [ ] [ ].m., on [ ], 20\_, or at such other time and place as the Company and the Purchasers mutually agree upon, orally or in writing (which time and place are designated as the “**Initial Closing**”).<sup>3</sup> In the event there is more than one closing, the term “**Closing**” shall apply to each such closing unless otherwise specified.

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<sup>1</sup> If only one closing is contemplated, references to “Initial Closing,” “each Closing,” “such Closing” etc. should be modified.

<sup>2</sup> Sometimes only a Certificate of Amendment is required.

<sup>3</sup> If the Agreement is signed prior to the Closing, this provision gives the parties flexibility to change the closing date as contingencies arise. As a practical matter, however, the Agreement is usually signed on the date of the Closing. This means that, until the Closing, everyone has an opportunity to back out of the deal.

(b) At each Closing, the Company shall deliver to each Purchaser a certificate representing the Shares being purchased by such Purchaser at such Closing against payment of the purchase price therefor by check payable to the Company, by wire transfer to a bank account designated by the Company, by cancellation or conversion of indebtedness of the Company to Purchaser [, including interest<sup>4</sup>], or by any combination of such methods.

### 1.3 Sale of Additional Shares of Preferred Stock.

(a) After the Initial Closing, the Company may sell, on the same terms and conditions as those contained in this Agreement<sup>5</sup>, up to [\_\_\_\_\_] additional shares (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or similar recapitalization affecting such shares) of Series A Preferred Stock (the “**Additional Shares**”), to one or more purchasers (the “**Additional Purchasers**”) [reasonably acceptable to Purchasers holding a [specify percentage] of the then outstanding Shares<sup>6</sup>], provided that (i) such subsequent sale is consummated prior to [90] days after the Initial Closing, (ii) each Additional Purchaser shall become a party to the Transaction Agreements, (as defined below) (other than the Management Rights Letter), by executing and delivering a counterpart signature page to each of the Transaction Agreements[, and (iii) [\_\_\_\_\_] counsel for the Company, provides an opinion dated as of the date of such Closing that the offer, issuance, sale and delivery of the Additional Shares to the Additional Purchasers do not require registration under the Securities Act of 1933, as amended, or applicable state securities laws.] Exhibit A to this Agreement shall be updated to reflect the number of Additional Shares purchased at each such Closing and the parties purchasing such Additional Shares.

(b) [After the Initial Closing, the Company shall sell, and the Purchasers shall purchase, on the same terms and conditions as those contained in this Agreement, up to [\_\_\_\_\_] additional shares of Series A Preferred Stock (the “**Milestone Shares**”), *pro rata* in accordance with the number of Shares being purchased by each such Purchaser at all prior Closings, on the certification by the [Board] [Purchasers] that the events specified in Exhibit J attached to this Agreement have occurred (the “**Milestone Events**”).

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<sup>4</sup> If some or all of the Purchasers will be converting previously issued notes to Shares, consider paying the interest in cash, if the terms of the notes permit this, to avoid last-minute recomputations if the closing is delayed. Note that cancellation of interest in return for stock may be a taxable event in the amount of the interest cancelled. Accordingly, some of the Purchasers may require payment of interest in cash to avoid imputation of income without the corresponding payment of cash to pay the tax.

<sup>5</sup> The Company will often try to negotiate a “cushion” in the negotiated limit of the number of preferred shares in order to permit it to issue additional shares of preferred stock in transactions outside the financing, e.g., warrants for preferred stock issued in connection with an equipment financing. The language “on the same terms and conditions as those contained in this Agreement” is flexible enough to permit this. If the investors want to limit the number of preferred shares to be issued to those preferred shares issued in the financing, the language “pursuant to this Agreement” should be substituted.

<sup>6</sup> The Company may want to limit this approval right to the larger Purchasers. As an alternative, the Agreement may specify that Additional Purchasers must be approved by the Board of Directors, including the directors elected by the Series A Preferred Stockholders.

The date of the purchase and sale of the Milestone Shares are referred to in this Agreement as the “**Milestone Closing.**”<sup>7]</sup>

1.4 [Use of Proceeds. In accordance with the directions of the Company’s Board of Directors, as it shall be constituted in accordance with the Voting Agreement, the Company will use the proceeds from the sale of the Shares for product development and other general corporate purposes.]

1.5 Defined Terms Used in this Agreement. In addition to the terms defined above, the following terms used in this Agreement shall be construed to have the meanings set forth or referenced below.

(a) “**Affiliate**” means, with respect to any specified Person, any other Person who, directly or indirectly, controls, is controlled by, or is under common control with such Person, including, without limitation, any general partner, managing member, officer or director of such Person or any venture capital fund now or hereafter existing that is controlled by one or more general partners or managing members of, or shares the same management company with, such Person.

(b) “**Code**” means the Internal Revenue Code of 1986, as amended.

(c) “**Company Intellectual Property**” means all patents, patent applications, trademarks, trademark applications, service marks, service mark applications, tradenames, copyrights, trade secrets, domain names, mask works, information and proprietary rights and processes, similar or other intellectual property rights, subject matter of any of the foregoing, tangible embodiments of any of the foregoing, licenses in to and under any of the foregoing, and any and all such cases [that are owned or used by] [as are necessary to] the Company in the conduct of the Company’s business as now conducted and as presently proposed to be conducted.

(d) “**Indemnification Agreement**” means the agreement between the Company and the director [and Purchaser Affiliates]<sup>8</sup> designated by any Purchaser entitled to designate a member of the Board of Directors pursuant to the Voting Agreement, dated as of the date of the Initial Closing, in the form of Exhibit D attached to this Agreement.

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<sup>7</sup> Consider whether the obligations of each Purchaser at a Milestone Closing are conditioned on (i) the representations and warranties remaining true (or materially so) as of such Milestone Closing, (ii) each other Purchaser purchasing shares at the Milestone Closing (i.e., if one Purchaser breaches then no others are obligated), and (iii) any other conditions. In a tranching milestone funding, investors should confirm with their accountants prior to the first closing that the initial and later tranches will not be treated as separate instruments for purposes of ASC 480 based on the specific structure of the transaction.

<sup>8</sup> See Model Indemnification Agreement for discussion of the issue of expanding coverage to include not just VC designee director, but also the fund(s) making the investment.

(e) “**Investors’ Rights Agreement**” means the agreement among the Company and the Purchasers<sup>9</sup> [and certain other stockholders of the Company] dated as of the date of the Initial Closing, in the form of Exhibit E attached to this Agreement.

(f) “**Key Employee**” means any executive-level employee (including division director and vice president-level positions) as well as any employee or consultant who either alone or in concert with others develops, invents, programs or designs any Company Intellectual Property.<sup>10</sup>

(g) “**Knowledge**,” including the phrase “**to the Company’s knowledge**,” shall mean the actual knowledge [after reasonable investigation] of the following officers: [specify names].<sup>11</sup>

(h) “**Management Rights Letter**” means the agreement between the Company and [Purchaser], dated as of the date of the Initial Closing, in the form of Exhibit F attached to this Agreement.

(i) “**Material Adverse Effect**” means a material adverse effect on the business, assets (including intangible assets), liabilities, financial condition, property, prospects<sup>12</sup> or results of operations of the Company.

(j) “**Person**” means any individual, corporation, partnership, trust, limited liability company, association or other entity.

(k) “**Purchaser**” means each of the Purchasers who is initially a party to this Agreement and any Additional Purchaser who becomes a party to this Agreement at a subsequent Closing under Subsection 1.3.

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<sup>9</sup> In Series A Preferred Stock financings, the Investors’ Rights Agreement will normally be signed by all the Series A Purchasers. In subsequent financing rounds, the standard practice is to amend and restate the Investor Rights Agreement, which will then be signed by the Company as well as the subsequent and prior round purchasers.

<sup>10</sup> In a Series A round at a high-tech start-up, it is likely that the only key employees in addition to management, if any, are those who are responsible for developing the Company’s key intellectual property assets. It may be simpler for these early-stage companies to list the Key Employees by name. In later rounds, it may be appropriate to include others, e.g., important salespeople or consultants and define Key Employees by function (e.g., division director).

<sup>11</sup> An important point of negotiation is often whether the Company will represent that a given fact (a) is true or (b) is true to the Company’s knowledge. Alternative (a) requires the Company to bear the entire risk of the truth or falsity of the represented fact, regardless whether the Company knew (or could have known) at the time of the representation whether or not the fact was true. Alternative (b) is preferable from the Company’s standpoint, since it holds the Company responsible only for facts of which it is actually aware.

<sup>12</sup> Since the prospects of high-tech start-up companies are by definition highly uncertain, the Company may resist the inclusion of the word “prospects” on the grounds that investors in a Series A financing are in the business of shouldering that risk.

(l) “**Right of First Refusal and Co-Sale Agreement**” means the agreement among the Company, the Purchasers, and certain other stockholders of the Company, dated as of the date of the Initial Closing, in the form of Exhibit G attached to this Agreement.

(m) “**Securities Act**” means the Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder.

(n) “**Shares**” means the shares of Series A Preferred Stock issued at the Initial Closing and any [Milestone Shares or] Additional Shares issued at a subsequent Closing under Subsection 1.3.

(o) “**Transaction Agreements**” means this Agreement, the Investors’ Rights Agreement, the Management Rights Letter, the Right of First Refusal and Co-Sale Agreement, the Voting Agreement and [list any other agreements, instruments or documents entered into in connection with this Agreement].

(p) “**Voting Agreement**” means the agreement among the Company, the Purchasers and certain other stockholders of the Company, dated as of the date of the Initial Closing, in the form of Exhibit H attached to this Agreement.

2. Representations and Warranties of the Company. The Company hereby represents and warrants to each Purchaser that, except as set forth on the Disclosure Schedule attached as Exhibit C to this Agreement, which exceptions shall be deemed to be part of the representations and warranties made hereunder, the following representations are true and complete as of the date of the Initial Closing, except as otherwise indicated. The Disclosure Schedule shall be arranged in sections corresponding to the numbered and lettered sections and subsections contained in this Section 2, and the disclosures in any section or subsection of the Disclosure Schedule shall qualify other sections and subsections in this Section 2 only to the extent it is readily apparent from a reading of the disclosure that such disclosure is applicable to such other sections and subsections.<sup>13</sup>

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<sup>13</sup> The purpose of the Company’s representations is primarily to create a mechanism to ensure full disclosure about the Company’s organization, financial condition and business to the investors. The Company is required to list any deviations from the representations on a Disclosure Schedule, the preparation and review of which drives the due diligence process on both sides of the deal. For subsequent closings, changes to the Disclosure Schedule are sometimes simply referenced on the Compliance Certificate. The introductory paragraph to this Section 2 may be modified to permit an update to the Disclosure Schedule that would be reasonably acceptable to each of the Purchasers. If this modification is made, a closing condition should be added to indicate that the updated Disclosure Schedule will be delivered and that each of the Purchasers may refuse to close if the updated Disclosure Schedule is reasonably unacceptable to that Purchaser. If there is to be a Milestone Closing, specific representations and warranties to be true as of the Milestone Closing date may need to be negotiated. Some practitioners prefer to deliver the Disclosure Schedule separately, instead of as an exhibit to the Stock Purchase Agreement, so that the Disclosure Schedule will not have to be publicly filed in the event the Stock Purchase Agreement is filed as an exhibit to a public offering registration statement.

For purposes of these representations and warranties (other than those in Subsections 2.2, 2.3, 2.4, 2.5, and 2.6), the term “the Company” shall include any subsidiaries of the Company, unless otherwise noted herein.

2.1 Organization, Good Standing, Corporate Power and Qualification.<sup>14</sup> The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware and has all requisite corporate power and authority to carry on its business as presently conducted and as proposed to be conducted. The Company is duly qualified to transact business and is in good standing in each jurisdiction in which the failure to so qualify would have a Material Adverse Effect.

2.2 Capitalization.<sup>15</sup>

(a) The authorized capital of the Company consists, immediately prior to the Initial Closing, of:

(i) [ ] shares of common stock, \$[ ] par value per share (the “Common Stock”), [ ] shares of which are issued and outstanding immediately prior to the Initial Closing. All of the outstanding shares of Common Stock have been duly authorized, are fully paid and nonassessable and were issued in compliance with all applicable federal and state securities laws. [The Company holds no Common Stock in its treasury.]

(ii) [ ] shares of Preferred Stock, of which [ ] shares have been designated Series A Preferred Stock, none of which are issued and outstanding immediately prior to the Initial Closing. The rights, privileges and preferences of the Preferred Stock are as stated in the Restated Certificate and as provided by the Delaware General Corporation Law [The Company holds no Preferred Stock in its treasury.]

(b) The Company has reserved [ ] shares of Common Stock for issuance to officers, directors, employees and consultants of the Company pursuant to its [Plan Year] Stock [Option] Plan duly adopted by the Board of Directors and approved by the

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<sup>14</sup> The purpose of this representation is to ensure that basic corporate maintenance has been properly carried out by the Company. Note that the Company is required to disclose failure to qualify in other jurisdictions where it does business only if failure to do so could have a “material adverse effect;” the purpose of this language is to eliminate the time and expense of doing a state-by-state analysis to determine whether the Company should technically be qualified. If the Company has material connections to states in which it is not qualified, these states must be investigated by counsel to determine whether qualification is necessary and whether there are potential adverse effects of having failed to qualify.

<sup>15</sup> Subsection 2.2 describes the Company’s capital structure and can be stated either immediately prior to or upon the Initial Closing of the financing. This description details any outstanding rights or privileges with respect to the Company’s securities. In later round financings, this description would also list any co-sale rights and rights of first refusal granted to investors in prior rounds. In later round financings, consider adding representations that there have been no conversions of previously-issued preferred stock to common stock, the number of shares that would be outstanding on an as-converted-to-common stock basis and the current conversion ratios of each series of preferred stock.

Company stockholders (the “**Stock Plan**”). Of such reserved shares of Common Stock, [ ] shares have been issued pursuant to restricted stock purchase agreements, options to purchase [ ] shares have been granted and are currently outstanding, and [ ] shares of Common Stock remain available for issuance to officers, directors, employees and consultants pursuant to the Stock Plan. The Company has furnished to the Purchasers complete and accurate copies of the Stock Plan and forms of agreements used thereunder.

(c) Subsection 2.2(c) of the Disclosure Schedule sets forth the capitalization of the Company immediately following the Initial Closing including the number of shares of the following: (i) issued and outstanding Common Stock, including, with respect to restricted Common Stock, vesting schedule and repurchase price; (ii) granted stock options, including vesting schedule and exercise price; (iii) shares of Common Stock reserved for future award grants under the Stock Plan; (iv) each series of Preferred Stock; and (v) warrants or stock purchase rights, if any.<sup>16</sup> Except for (A) the conversion privileges of the Shares to be issued under this Agreement, (B) the rights provided in Section 4 of the Investors’ Rights Agreement, and (C) the securities and rights described in Subsection 2.2(b) of this Agreement and Subsection 2.2(c) of the Disclosure Schedule, there are no outstanding options, warrants, rights (including conversion or preemptive rights and rights of first refusal or similar rights) or agreements, orally or in writing, to purchase or acquire from the Company any shares of Common Stock or Series A Preferred Stock, or any securities convertible into or exchangeable for shares of Common Stock or Series A Preferred Stock. All outstanding shares of the Company’s Common Stock and all shares of the Company’s Common Stock underlying outstanding options are subject to (i) a right of first refusal in favor of the Company upon any proposed transfer (other than transfers for estate planning purposes); and (ii) a lock-up or market standoff agreement of not less than 180 days following the Company’s initial public offering pursuant to a registration statement filed with the Securities and Exchange Commission under the Securities Act.

(d) None of the Company’s stock purchase agreements or stock option documents contains a provision for acceleration of vesting (or lapse of a repurchase right) or other changes in the vesting provisions or other terms of such agreement or understanding upon the occurrence of any event or combination of events, including without limitation in the case where the Company’s Stock Plan is not assumed in an acquisition. The Company has never adjusted or amended the exercise price of any stock options previously awarded, whether through amendment, cancellation, replacement grant, repricing, or any other means. Except as set forth in the Restated Certificate, the Company has no obligation (contingent or otherwise) to purchase or redeem any of its capital stock.

(e) [409A]. The Company believes in good faith that any “nonqualified deferred compensation plan” (as such term is defined under Section 409A(d)(1) of the Code and the guidance thereunder) under which the Company makes, is obligated to make or promises to make, payments (each, a “**409A Plan**”) complies in all material respects, in both

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<sup>16</sup> Some practitioners prefer to delete this representation, provided the capitalization table is a separate document.

form and operation, with the requirements of Section 409A of the Code and the guidance thereunder. To the knowledge of the Company, no payment to be made under any 409A Plan is, or will be, subject to the penalties of Section 409A(a)(1) of the Code.]<sup>17</sup>

(f) The Company has obtained valid waivers of any rights by other parties to purchase any of the Shares covered by this Agreement.

2.3 Subsidiaries.<sup>18</sup> The Company does not currently own or control, directly or indirectly, any interest in any other corporation, partnership, trust, joint venture, limited liability company, association, or other business entity. The Company is not a participant in any joint venture, partnership or similar arrangement.

2.4 Authorization.<sup>19</sup> All corporate action required to be taken by the Company's Board of Directors and stockholders in order to authorize the Company to enter into the Transaction Agreements, and to issue the Shares at the Closing and the Common Stock issuable upon conversion of the Shares, has been taken or will be taken prior to the Closing. All action on the part of the officers of the Company necessary for the execution and delivery of the Transaction Agreements, the performance of all obligations of the Company under the Transaction Agreements to be performed as of the Closing, and the issuance and delivery of the Shares has been taken or will be taken prior to the Closing. The Transaction Agreements, when executed and delivered by the Company, shall constitute valid and legally binding obligations of the Company, enforceable against the Company in accordance with their respective terms except (i) as limited by applicable bankruptcy, insolvency, reorganization, moratorium, fraudulent conveyance, or other laws of general application relating to or affecting the enforcement of creditors' rights generally, (ii) as limited by laws relating to the availability of specific performance, injunctive relief, or other equitable remedies, or (iii) to the extent the indemnification provisions contained in the Investors' Rights Agreement and the Indemnification Agreement may be limited by applicable federal or state securities laws.

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<sup>17</sup> It should be noted that the consensus among the NVCA drafting group was that the 409A issues are better dealt with as a diligence item, rather than a company rep. Nevertheless, this rep is included here because it is in any case important that the issue be surfaced as part of the financing, to ensure that the company is mindful of the obligations and potential penalties imposed by 409A as it makes future equity grants. Inserting the rep in the first draft, as a discussion item, is one way to ensure that the issue is not neglected.

<sup>18</sup> The purpose of this representation is to require the Company to fully disclose its structure, including other corporations, if any, that it controls. If the Company does have subsidiaries, you should (i) add to Subsection 2.3 a representation with respect to the subsidiaries of the Company modeled after Subsection 2.1 regarding the organization, good standing and qualification of each such subsidiary, and (ii) add a reference to subsidiaries where appropriate in Section 2. Some formulations include subsidiaries in the definition of the Company, this approach works if careful attention is given to representations where the effect of such inclusion requires additional language (for example, the representation in Subsection 2.2 would require either the exclusion of subsidiaries or a separate paragraph regarding the capitalization of subsidiaries).

<sup>19</sup> In certain jurisdictions, ancillary agreements executed in connection with the financing, such as noncompetition provisions or voting agreements, may be subject to some question regarding their enforceability, and the representation should be modified accordingly and (ii) add references to subsidiaries throughout Section 2 or add a representation here that the appropriate sections of Section 2 also apply with respect to the subsidiaries of the Company.



2.5 Valid Issuance of Shares.<sup>20</sup> The Shares, when issued, sold and delivered in accordance with the terms and for the consideration set forth in this Agreement, will be validly issued, fully paid and nonassessable and free of restrictions on transfer other than restrictions on transfer under the Transaction Agreements, applicable state and federal securities laws and liens or encumbrances created by or imposed by a Purchaser. Assuming the accuracy of the representations of the Purchasers in Section 3 of this Agreement and subject to the filings described in Subsection 2.6(ii) below, the Shares will be issued in compliance with all applicable federal and state securities laws. The Common Stock issuable upon conversion of the Shares has been duly reserved for issuance, and upon issuance in accordance with the terms of the Restated Certificate, will be validly issued, fully paid and nonassessable and free of restrictions on transfer other than restrictions on transfer under the Transaction Agreements, applicable federal and state securities laws and liens or encumbrances created by or imposed by a Purchaser. Based in part upon the representations of the Purchasers in Section 3 of this Agreement, and subject to Subsection 2.6 below, the Common Stock issuable upon conversion of the Shares will be issued in compliance with all applicable federal and state securities laws.

2.6 Governmental Consents and Filings. Assuming the accuracy of the representations made by the Purchasers in Section 3 of this Agreement, no consent, approval, order or authorization of, or registration, qualification, designation, declaration or filing with, any federal, state or local governmental authority is required on the part of the Company in connection with the consummation of the transactions contemplated by this Agreement, except for (i) the filing of the Restated Certificate, which will have been filed as of the Initial Closing, and (ii) filings pursuant to Regulation D of the Securities Act, and applicable state securities laws, which have been made or will be made in a timely manner.

2.7 Litigation.<sup>21</sup> There is no claim, action, suit, proceeding, arbitration, complaint, charge or investigation<sup>22</sup> pending or to the Company's knowledge, currently threatened [in writing] (i) against the Company or any officer, director or Key Employee of the Company [arising out of their employment or board relationship with the Company]; [or] (ii) [to the Company's knowledge,] that questions the validity of the Transaction Agreements or the

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<sup>20</sup> The representations in Subsections 2.4 and 2.5 are intended to ensure that the Company has taken all steps necessary to issue the preferred stock in accordance with applicable corporate law. This means that, before the closing, the Company must (A) obtain the requisite stockholder and board approvals to amend the Certificate of Incorporation and issue the stock; (B) file the Restated Certificate and (C) obtain any other stockholder consents or waivers required pursuant to the Restated Certificate, Bylaws, and existing agreements with securityholders (most importantly, waivers to any existing rights of first offer or refusal). Subsection 2.5 also requires the Company to disclose any restrictions on transfer other than those contained in the Transaction Agreements (such as any contained in the Restated Certificate and Bylaws, or any preemptive rights contained in agreements with other securityholders).

<sup>21</sup> The litigation representation will often be unqualified in Series A financings. The bracketed materiality qualifiers are more common in later rounds of financings. In subsequent rounds it is no longer appropriate to have the Company make representations regarding directors (as opposed to employees), since directors will include investor representatives.

<sup>22</sup> It may be appropriate to include a knowledge qualifier as to investigations since it would be difficult for the Company to know of an investigation unless it had been notified. Some investors nevertheless feel the risk is appropriately borne by the Company.

right of the Company to enter into them, or to consummate the transactions contemplated by the Transaction Agreements; [or (iii) to the Company's knowledge, that would reasonably be expected to have, either individually or in the aggregate, a Material Adverse Effect.] Neither the Company nor, to the Company's knowledge, any of its officers, directors or Key Employees is a party or is named as subject to the provisions of any order, writ, injunction, judgment or decree of any court or government agency or instrumentality (in the case of officers, directors or Key Employees, such as would affect the Company). There is no action, suit, proceeding or investigation by the Company pending or which the Company intends to initiate. The foregoing includes, without limitation, actions, suits, proceedings or investigations pending or threatened in writing (or any basis therefor known to the Company) involving the prior employment of any of the Company's employees, their services provided in connection with the Company's business, or any information or techniques allegedly proprietary to any of their former employers, or their obligations under any agreements with prior employers.

2.8 Intellectual Property.<sup>23</sup> [The Company owns or possesses or [believes it] can acquire on commercially reasonable terms sufficient legal rights to all Company Intellectual Property without any known conflict with, or infringement of, the rights of others.] To the Company's knowledge, no product or service marketed or sold (or proposed to be marketed or sold) by the Company violates or will violate any license or infringes or will infringe any intellectual property rights of any other party. Other than with respect to commercially available software products under standard end-user object code license agreements, there are no outstanding options, licenses, agreements, claims, encumbrances or shared ownership interests of any kind relating to the Company Intellectual Property, nor is the Company bound by or a party to any options, licenses or agreements of any kind with respect to the patents, trademarks, service marks, trade names, copyrights, trade secrets, licenses, information, proprietary rights and processes of any other Person. The Company has not received any communications alleging that the Company has violated or, by conducting its business, would violate any of the patents, trademarks, service marks, tradenames, copyrights, trade secrets, mask works or other proprietary rights or processes of any other Person. The Company has obtained and possesses valid licenses to use all of the software programs present on the computers and other software-enabled electronic devices that it owns or leases or that it has otherwise provided to its employees for their use in connection with the Company's business. To the Company's knowledge, it will not be necessary to use any inventions of any of its employees or consultants (or Persons it currently intends to hire) made prior to their employment by the Company. Each employee and consultant has assigned to the Company all intellectual property rights he or she owns that are related to the Company's business as now conducted and as presently proposed to be conducted. Subsection 2.8 of the Disclosure Schedule lists all Company Intellectual

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<sup>23</sup> Subsection 2.8 gives the Purchasers assurances that the Company has the intellectual property rights necessary to conduct its business, or has disclosed its need to acquire further rights. Although Purchasers prefer an unqualified representation, this provision is often heavily negotiated, and may be impossible for the Company to make with certainty for a product in a very early stage of development. Under a common compromise, the Company provides an unqualified representation with respect to everything but patents, on the theory that potential patent conflicts cannot always be uncovered even after reasonable investigation, and that patent conflicts therefore represent an unknown risk that is fairly borne by both parties.

Property.<sup>24</sup> The Company has not embedded any open source, copyleft or community source code in any of its products generally available or in development, including but not limited to any libraries or code licensed under any General Public License, Lesser General Public License or similar license arrangement.<sup>25</sup> For purposes of this Subsection 2.8, the Company shall be deemed to have knowledge of a patent right if the Company has actual knowledge of the patent right or would be found to be on notice of such patent right as determined by reference to United States patent laws.

2.9 Compliance with Other Instruments. The Company is not in violation or default (i) of any provisions of its Restated Certificate or Bylaws, (ii) of any instrument, judgment, order, writ or decree, (iii) under any note, indenture or mortgage, or (iv) under any lease, agreement, contract or purchase order to which it is a party or by which it is bound that is required to be listed on the Disclosure Schedule, or, (v) [to its knowledge,] of any provision of federal or state statute, rule or regulation applicable to the Company, the violation of which would have a Material Adverse Effect. The execution, delivery and performance of the Transaction Agreements and the consummation of the transactions contemplated by the

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<sup>24</sup> If you represent the Company, you may seek to use a more specific list of items (a subset of the broader definition of Company Intellectual Property) to be set forth on the Disclosure Schedule: “patents, patent applications, trademarks, trademark applications, service marks, service mark applications, tradenames, copyrights, and licenses to and under any of the foregoing.”

<sup>25</sup> This representation regarding non-use of open source software is intended to elicit disclosure of publicly available, third-party source code that the Company has incorporated, or intends to incorporate, into its products. In most cases, the Purchasers should be concerned primarily about use of third-party source code distributed under a license that requires the Company to disclose and distribute its own source code, that grants licensees rights under the Company’s patents, or that contains other provisions that relinquish or may compromise the Company’s intellectual property rights or commercial prospects. Much publicly available source code is distributed under licenses that permit it to be freely used and redistributed without imposing onerous obligations upon those that use it to develop their own software. Note also that the General Public License (GPL) and other so-called “viral” open source licenses impose potentially onerous obligations upon licensees only if code distributed under them is incorporated into a product that is actually released to the general public. Some proprietary software companies experiment with code distributed under the GPL during the development process with no intention of retaining GPL code in the products ultimately released to their customers. (This experimentation typically is done in a separate “branch” of the source code of a product in development.) The Company may wish to consider narrowing this representation to include use of third-party source code distributed under any license that imposes specified obligations upon the Company, and perhaps then only if the third party source code has been included in a product that the Company has released. An example of a reduced-disclosure open source representation is as follows: “The Company has not embedded, used or distributed any open source, copyleft or community source code (including but not limited to any libraries or code, software, technologies or other materials that are licensed or distributed under any General Public License, Lesser General Public License or similar license arrangement or other distribution model described by the Open Source Initiative at [www.opensource.org](http://www.opensource.org), collectively “**Open Source Software**”) in connection with any of its products or services that are generally available or in development in any manner that would materially restrict the ability of the Company to protect its proprietary interests in any such product or service or in any manner that requires, or purports to require: (i) any Company IP (other than the Open Source Software itself) be disclosed or distributed in source code form or be licensed for the purpose of making derivative works; (ii) any restriction on the consideration to be charged for the distribution of any Company IP; (iii) the creation of any obligation for the Company with respect to Company IP owned by the Company, or the grant to any third party of any rights or immunities under Company IP owned by the Company; or (iv) any other limitation, restriction or condition on the right of the Company with respect to its use or distribution of any Company IP.”

Transaction Agreements will not result in any such violation or be in conflict with or constitute, with or without the passage of time and giving of notice, either (i) a default under any such provision, instrument, judgment, order, writ, decree, contract or agreement or (ii) an event which results in the creation of any lien, charge or encumbrance upon any assets of the Company or the suspension, revocation, forfeiture, or nonrenewal of any material permit or license applicable to the Company.

## 2.10 Agreements; Actions.<sup>26</sup>

(a) Except for the Transaction Agreements, there are no agreements, understandings, instruments, contracts or proposed transactions to which the Company is a party or by which it is bound that involve (i) obligations (contingent or otherwise) of, or payments to, the Company in excess of [\_\_\_\_], (ii) the license of any patent, copyright, trademark, trade secret or other proprietary right to or from the Company, (iii) the grant of rights to manufacture, produce, assemble, license, market, or sell its products to any other Person that limit the Company's exclusive right to develop, manufacture, assemble, distribute, market or sell its products, or (iv) indemnification by the Company with respect to infringements of proprietary rights.

(b) The Company has not (i) declared or paid any dividends, or authorized or made any distribution upon or with respect to any class or series of its capital stock, (ii) incurred any indebtedness for money borrowed or incurred any other liabilities individually in excess of [\_\_\_\_] or in excess of [\_\_\_\_] in the aggregate, (iii) made any loans or advances to any Person, other than ordinary advances for travel expenses, or (iv) sold, exchanged or otherwise disposed of any of its assets or rights, other than the sale of its inventory in the ordinary course of business. For the purposes of subsections (b) and (c) of this Subsection 2.10, all indebtedness, liabilities, agreements, understandings, instruments, contracts and proposed transactions involving the same Person (including Persons the Company has reason to believe are affiliated with each other) shall be aggregated for the purpose of meeting the individual minimum dollar amounts of such subsection.

(c) The Company is not a guarantor or indemnitor of any indebtedness of any other Person.

(d) [The Company has not engaged in the past [three (3) months] in any discussion with any representative of any Person regarding (i) a sale or exclusive license of all or substantially all of the Company's assets, or (ii) any merger, consolidation or other business combination transaction of the Company with or into another Person.]<sup>27</sup>

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<sup>26</sup> Subsections 2.10(a) and (a) require the Company to disclose material contracts as well as other agreements or arrangements that might be important from a due diligence standpoint regardless of dollar amount (such as intellectual property licenses or a proposed acquisition of the Company). The disclosure thresholds are negotiable.

<sup>27</sup> This representation is not standard, but is sometimes requested by investors concerned that the Company might be considering a business combination transaction.

## 2.11 Certain Transactions.<sup>28</sup>

(a) Other than (i) standard employee benefits generally made available to all employees, (ii) standard director and officer indemnification agreements approved by the Board of Directors, and (iii) the purchase of shares of the Company's capital stock and the issuance of options to purchase shares of the Company's Common Stock, in each instance, approved in the written minutes of the Board of Directors (previously provided to the Purchasers or their counsel), there are no agreements, understandings or proposed transactions between the Company and any of its officers, directors, consultants or Key Employees, or any Affiliate thereof.

(b) The Company is not indebted, directly or indirectly, to any of its directors, officers or employees or to their respective spouses or children or to any Affiliate of any of the foregoing, other than in connection with expenses or advances of expenses incurred in the ordinary course of business or employee relocation expenses and for other customary employee benefits made generally available to all employees. None of the Company's directors, officers or employees, or any members of their immediate families, or any Affiliate of the foregoing are, directly or indirectly, indebted to the Company[ or, [to the Company's knowledge], have any (i) material commercial, industrial, banking, consulting, legal, accounting, charitable or familial relationship with any of the Company's customers, suppliers, service providers, joint venture partners, licensees and competitors, (ii) direct or indirect ownership interest in any firm or corporation with which the Company is affiliated or with which the Company has a business relationship, or any firm or corporation which competes with the Company except that directors, officers or employees or stockholders of the Company may own stock in (but not exceeding two percent (2%) of the outstanding capital stock of) publicly traded companies that may compete with the Company or (iii) financial interest in any [material] contract with the Company].<sup>29</sup>

2.12 Rights of Registration and Voting Rights.<sup>30</sup> Except as provided in the Investors' Rights Agreement, the Company is not under any obligation to register under the Securities Act any of its currently outstanding securities or any securities issuable upon exercise

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<sup>28</sup> This representation requires disclosure of situations which could create a conflict of interest. This is an item of particular concern in the first round of venture capital financing, since loans among the Company and its founders and their families (which may not be well documented) are especially common prior to the first infusion of outside capital.

<sup>29</sup> The bracketed portion of this sentence may be a broader representation than the Company is comfortable giving. In addition, it is appropriate to include directors throughout this section only at the first financing round. In subsequent rounds the directors will include investor representatives, and it should not be incumbent on the Company to make disclosures as to them.

<sup>30</sup> Prior registration rights may conflict with those currently being negotiated among the investors and the Company. Therefore, any such rights must be carefully reviewed and any conflicts resolved. It is common to have any previous registration rights agreement amended to include the new investors, or replaced by a new agreement including the old and new investors and clarifying their rights relative to each other as well as the Company. It is preferable to have all registration rights relating to the Company's securities set forth in one document. Having several different sets of rights outstanding can be a significant (and confusing) complication when the Company goes public.

or conversion of its currently outstanding securities. To the Company's knowledge, except as contemplated in the Voting Agreement, no stockholder of the Company has entered into any agreements with respect to the voting of capital shares of the Company.

2.13 Property. The property and assets that the Company owns are free and clear of all mortgages, deeds of trust, liens, loans and encumbrances, except for statutory liens for the payment of current taxes that are not yet delinquent and encumbrances and liens that arise in the ordinary course of business and do not materially impair the Company's ownership or use of such property or assets. With respect to the property and assets it leases, the Company is in compliance with such leases and, to its knowledge, holds a valid leasehold interest free of any liens, claims or encumbrances other than those of the lessors of such property or assets. The Company does not own any real property.

2.14 Financial Statements.<sup>31</sup> The Company has delivered to each Purchaser its [unaudited] [audited] financial statements as of [\_\_\_\_\_, 20\_] and for the fiscal year ended [\_\_\_\_\_, 20\_] [and its unaudited financial statements (including balance sheet, income statement and statement of cash flows) as of [\_\_\_\_\_, 20\_] and for the [\_\_\_\_\_] -month period ended [\_\_\_\_\_, 20\_]] (collectively, the "**Financial Statements**"). The Financial Statements have been prepared in accordance with generally accepted accounting principles applied on a consistent basis throughout the periods indicated, [except that the unaudited Financial Statements may not contain all footnotes required by generally accepted accounting principles]. The Financial Statements fairly present in all material respects the financial condition and operating results of the Company as of the dates, and for the periods, indicated therein, subject in the case of the unaudited Financial Statements to normal year-end audit adjustments. Except as set forth in the Financial Statements, the Company has no material liabilities or obligations, contingent or otherwise, other than (i) liabilities incurred in the ordinary course of business subsequent to [\_\_\_\_\_] (ii) obligations under contracts and commitments incurred in the ordinary course of business and (iii) liabilities and obligations of a type or nature not required under generally accepted accounting principles to be reflected in the Financial Statements, which, in all such cases, individually and in the aggregate would not have a Material Adverse Effect. The Company maintains and will continue to maintain a standard system of accounting established and administered in accordance with generally accepted accounting principles.

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<sup>31</sup> For early stage companies without financial statements, it may be appropriate to have an alternative provision, such as the following:

**Material Liabilities.** The Company has no liability or obligation, absolute or contingent (individually or in the aggregate), except (i) obligations and liabilities incurred after the date of incorporation in the ordinary course of business that are not material, individually or in the aggregate, and (ii) obligations under contracts made in the ordinary course of business that would not be required to be reflected in financial statements prepared in accordance with generally accepted accounting principles.

2.15 Changes.<sup>32</sup> Since [date of most recent financial statements/date of incorporation if no financial statements] there has not been:

(a) any change in the assets, liabilities, financial condition or operating results of the Company from that reflected in the Financial Statements, except changes in the ordinary course of business that have not caused, in the aggregate, a Material Adverse Effect;

(b) any damage, destruction or loss, whether or not covered by insurance, that would have a Material Adverse Effect;

(c) any waiver or compromise by the Company of a valuable right or of a material debt owed to it;

(d) any satisfaction or discharge of any lien, claim, or encumbrance or payment of any obligation by the Company, except in the ordinary course of business and the satisfaction or discharge of which would not have a Material Adverse Effect;

(e) any material change to a material contract or agreement by which the Company or any of its assets is bound or subject;

(f) any material change in any compensation arrangement or agreement with any employee, officer, director or stockholder;

(g) any resignation or termination of employment of any officer or Key Employee of the Company;

(h) any mortgage, pledge, transfer of a security interest in, or lien, created by the Company, with respect to any of its material properties or assets, except liens for taxes not yet due or payable and liens that arise in the ordinary course of business and do not materially impair the Company's ownership or use of such property or assets;

(i) any loans or guarantees made by the Company to or for the benefit of its employees, officers or directors, or any members of their immediate families, other than travel advances and other advances made in the ordinary course of its business;

(j) any declaration, setting aside or payment or other distribution in respect of any of the Company's capital stock, or any direct or indirect redemption, purchase, or other acquisition of any of such stock by the Company;

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<sup>32</sup> The purpose of this representation is to "bring down" the financial statements from the period covered thereby. Therefore, the blank in Subsection 2.15 should be filled with the last date covered by the financial statements provided to the investors, and any of the changes listed in this section must be disclosed on the Disclosure Schedule. While the itemization in this section serves as a useful due diligence checklist, this section can be replaced by a much shorter section reading simply, "[To the Company's knowledge], since [\_\_\_\_], there have been no events or circumstances of any kind that have had or could reasonably be expected to result in a Material Adverse Effect."

(k) any sale, assignment or transfer of any Company Intellectual Property that could reasonably be expected to result in a Material Adverse Effect;

(l) receipt of notice that there has been a loss of, or material order cancellation by, any major customer of the Company;

(m) to the Company's knowledge, any other event or condition of any character, other than events affecting the economy or the Company's industry generally, that could reasonably be expected to result in a Material Adverse Effect; or

(n) any arrangement or commitment by the Company to do any of the things described in this Subsection 2.15.

#### 2.16 Employee Matters.

(a) As of the date hereof, the Company employs [\_\_\_\_\_] full-time employees and [\_\_\_\_\_] part-time employees and engages [\_\_\_\_\_] consultants or independent contractors. [Subsection 2.16 of] the Disclosure Schedule sets forth a detailed description of all compensation, including salary, bonus, severance obligations and deferred compensation paid or payable for each officer, employee, consultant and independent contractor of the Company who received compensation in excess of \$[\_\_\_\_\_] for the fiscal year ended [\_\_\_\_\_, 20\_] or is anticipated to receive compensation in excess of \$[\_\_\_\_\_] for the fiscal year ending [\_\_\_\_\_, 20\_].<sup>33</sup>

(b) To the Company's knowledge, none of its employees is obligated under any contract (including licenses, covenants or commitments of any nature) or other agreement, or subject to any judgment, decree or order of any court or administrative agency, that would materially interfere with such employee's ability to promote the interest of the Company or that would conflict with the Company's business. Neither the execution or delivery of the Transaction Agreements, nor the carrying on of the Company's business by the employees of the Company, nor the conduct of the Company's business as now conducted and as presently proposed to be conducted, will, to the Company's knowledge, conflict with or result in a breach of the terms, conditions, or provisions of, or constitute a default under, any contract, covenant or instrument under which any such employee is now obligated.

(c) The Company is not delinquent in payments to any of its employees, consultants, or independent contractors for any wages, salaries, commissions, bonuses, or other direct compensation for any service performed for it to the date hereof or amounts required to be reimbursed to such employees, consultants, or independent contractors. The Company has complied in all material respects with all applicable state and federal equal employment opportunity laws and with other laws related to employment, including those related

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<sup>33</sup> Many practitioners prefer not to list employee compensation in the Disclosure Schedule, particularly if employees are participating in the round. Even if there is no employee participation, however, employee compensation is a sensitive matter for many companies, and there is always a risk of the Disclosure Schedule inadvertently winding up in the wrong hands.



to wages, hours, worker classification, and collective bargaining. The Company has withheld and paid to the appropriate governmental entity or is holding for payment not yet due to such governmental entity all amounts required to be withheld from employees of the Company and is not liable for any arrears of wages, taxes, penalties, or other sums for failure to comply with any of the foregoing.

(d) To the Company's knowledge, no Key Employee intends to terminate employment with the Company or is otherwise likely to become unavailable to continue as a Key Employee, nor does the Company have a present intention to terminate the employment of any of the foregoing. The employment of each employee of the Company is terminable at the will of the Company. Except as set forth in Subsection 2.16 of the Disclosure Schedule or as required by law, upon termination of the employment of any such employees, no severance or other payments will become due. Except as set forth in Subsection 2.16 of the Disclosure Schedule, the Company has no policy, practice, plan, or program of paying severance pay or any form of severance compensation in connection with the termination of employment services.

(e) The Company has not made any representations regarding equity incentives to any officer, employees, director or consultant that are inconsistent with the share amounts and terms set forth in the minutes of meetings of the Company's board of directors.

(f) Each former Key Employee whose employment was terminated by the Company has entered into an agreement with the Company providing for the full release of any claims against the Company or any related party arising out of such employment.

(g) Subsection 2.16 of the Disclosure Schedule sets forth each employee benefit plan maintained, established or sponsored by the Company, or which the Company participates in or contributes to, which is subject to the Employee Retirement Income Security Act of 1974, as amended ("ERISA"). The Company has made all required contributions and has no liability to any such employee benefit plan, other than liability for health plan continuation coverage described in Part 6 of Title I(B) of ERISA, and has complied in all material respects with all applicable laws for any such employee benefit plan.

(h) [The Company is not bound by or subject to (and none of its assets or properties is bound by or subject to) any written or oral, express or implied, contract, commitment or arrangement with any labor union, and no labor union has requested or, to the knowledge of the Company, has sought to represent any of the employees, representatives or agents of the Company. There is no strike or other labor dispute involving the Company pending, or to the Company's knowledge, threatened, which could have a Material Adverse Effect, nor is the Company aware of any labor organization activity involving its employees.]

(i) [To the Company's knowledge, none of the Key Employees or directors<sup>34</sup> of the Company has been (a) subject to voluntary or involuntary petition under the

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<sup>34</sup> See footnote 29 – same point as to investor directors.

federal bankruptcy laws or any state insolvency law or the appointment of a receiver, fiscal agent or similar officer by a court for his business or property; (b) convicted in a criminal proceeding or named as a subject of a pending criminal proceeding (excluding traffic violations and other minor offenses); (c) subject to any order, judgment, or decree (not subsequently reversed, suspended, or vacated) of any court of competent jurisdiction permanently or temporarily enjoining him from engaging, or otherwise imposing limits or conditions on his engagement in any securities, investment advisory, banking, insurance, or other type of business or acting as an officer or director of a public company; or (d) found by a court of competent jurisdiction in a civil action or by the Securities and Exchange Commission or the Commodity Futures Trading Commission to have violated any federal or state securities, commodities, or unfair trade practices law, which such judgment or finding has not been subsequently reversed, suspended, or vacated.]

2.17 Tax Returns and Payments. There are no federal, state, county, local or foreign taxes dues and payable by the Company which have not been timely paid. There are no accrued and unpaid federal, state, county, local or foreign taxes of the Company which are due, whether or not assessed or disputed. There have been no examinations or audits of any tax returns or reports by any applicable federal, state, local or foreign governmental agency. The Company has duly and timely filed all federal, state, county, local and foreign tax returns required to have been filed by it and there are in effect no waivers of applicable statutes of limitations with respect to taxes for any year.

2.18 Insurance.<sup>35</sup> The Company has in full force and effect fire and casualty insurance policies with extended coverage, sufficient in amount (subject to reasonable deductions) to allow it to replace any of its properties that might be damaged or destroyed.

2.19 Employee Agreements. Each current and former employee, consultant and officer of the Company has executed an agreement with the Company regarding confidentiality and proprietary information substantially in the form or forms delivered to the counsel for the Purchasers (the “**Confidential Information Agreements**”). No current or former Key Employee has excluded works or inventions from his or her assignment of inventions pursuant to such Key Employee’s Confidential Information Agreement. Each current and former Key Employee has executed a [non-competition and] non-solicitation agreement substantially in the form or forms delivered to counsel for the Purchasers. The Company is not aware that any of its Key Employees is in violation of any agreement covered by this Subsection 2.19.

2.20 Permits. The Company has all franchises, permits, licenses and any similar authority necessary for the conduct of its business, the lack of which could reasonably be expected to have a Material Adverse Effect. The Company is not in default in any material respect under any of such franchises, permits, licenses or other similar authority.

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<sup>35</sup> The investors may negotiate life insurance coverage in favor of the Company for certain founders or other key employees. If such coverage is in effect prior to the closing, it may be appropriate to add to this representation a statement of the covered individuals and amount of coverage for each.

2.21 Corporate Documents. The Restated Certificate and Bylaws of the Company are in the form provided to the Purchasers. The copy of the minute books of the Company provided to the Purchasers contains minutes of all meetings of directors and stockholders and all actions by written consent without a meeting by the directors and stockholders since the date of incorporation and accurately reflects in all material respects all actions by the directors (and any committee of directors) and stockholders with respect to all transactions referred to in such minutes.

2.22 [83(b) Elections. To the Company's knowledge, all elections and notices under Section 83(b) of the Code have been or will be timely filed by all individuals who have acquired unvested shares of the Company's Common Stock.]<sup>36</sup>

2.23 [Real Property Holding Corporation.<sup>37</sup> The Company is not now and has never been a "United States real property holding corporation" as defined in the Code and any applicable regulations promulgated thereunder. The Company has filed with the Internal Revenue Service all statements, if any, with its United States income tax returns which are required under such regulations.]

2.24 Environmental and Safety Laws. Except as could not reasonably be expected to have a Material Adverse Effect [to the best of its knowledge] (a) the Company is and has been in compliance with all Environmental Laws; (b) there has been no release or [to the Company's knowledge] threatened release of any pollutant, contaminant or toxic or hazardous material, substance or waste, or petroleum or any fraction thereof, (each a "**Hazardous Substance**") on, upon, into or from any site currently or heretofore owned, leased or otherwise used by the Company; (c) there have been no Hazardous Substances generated by the Company that have been disposed of or come to rest at any site that has been included in any published U.S. federal, state or local "superfund" site list or any other similar list of hazardous or toxic waste sites published by any governmental authority in the United States; and (d) there are no underground storage tanks located on, no polychlorinated biphenyls ("**PCBs**") or PCB-containing equipment used or stored on, and no hazardous waste as defined by the Resource Conservation and Recovery Act, as amended, stored on, any site owned or operated by the Company, except for the storage of hazardous waste in compliance with Environmental Laws. The Company has made available to the Purchasers true and complete copies of all material

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<sup>36</sup> This representation is fairly standard in West Coast venture financing transactions; it is much less common in financings originating on the East Coast.

<sup>37</sup> This representation is appropriate if there are foreign investors (*i.e.*, nonresident aliens) involved in the financing, since they are subject to the Foreign Investment Real Property Tax Act of 1980 ("**FIRPTA**"). Under FIRPTA, a transfer of an interest in a U.S. Real Property Holding Corporation (a "**USRPHC**") by a foreign investor is subject to tax withholding, notwithstanding the general rule that sales of stock by foreigners are not subject to U.S. taxation. A corporation is USRPHC if more than 50% of its assets consist of U.S. real property. While very few, if any, venture capital investors are USRPHC's, it is customary to provide this representation in order to ensure that any foreign investors will not be subject to tax withholding. Regardless of FIRPTA, if a foreign person or entity is, directly or indirectly, acquiring an 10% or greater voting interest in the Company, it must file Form BE-13 with the U.S. Department of Commerce unless an exemption applies.

environmental records, reports, notifications, certificates of need, permits, pending permit applications, correspondence, engineering studies, and environmental studies or assessments.

For purposes of this Section 3, “Environmental Laws” means any law, regulation, or other applicable requirement relating to (a) releases or threatened release of Hazardous Substance; (b) pollution or protection of employee health or safety, public health or the environment; or (c) the manufacture, handling, transport, use, treatment, storage, or disposal of Hazardous Substances.

2.25 [Qualified Small Business Stock].<sup>38</sup> As of and immediately following the Closing: (i) the Company will be an eligible corporation as defined in Section 1202(e)(4) of the Code, (ii) the Company will not have made purchases of its own stock described in Code Section 1202(c)(3)(B) during the one-year period preceding the Initial Closing, except for purchases that are disregarded for such purposes under Treasury Regulation Section 1.1202-2 and (iii) the Company’s aggregate gross assets, as defined by Code Section 1202(d)(2), at no time between its incorporation and through the Initial Closing have exceeded \$50 million, taking into account the assets of any corporations required to be aggregated with the Company in accordance with Code Section 1202(d)(3); provided, however, that in no event shall the Company be liable to the Purchasers or any other party for any damages arising from any subsequently proven or identified error in the Company’s determination with respect to the applicability or interpretation of Code Section 1202, unless such determination shall have been given by the Company in a manner either grossly negligent or fraudulent.]

2.26 Disclosure.<sup>39</sup> The Company has made available to the Purchasers all the information reasonably available to the Company that the Purchasers have requested for deciding whether to acquire the Shares, including certain of the Company’s projections describing its proposed business plan (the “**Business Plan**”). No representation or warranty of the Company contained in this Agreement, as qualified by the Disclosure Schedule, and no certificate

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<sup>38</sup> Section 1202 of the Internal Revenue Code provides for a 50% exclusion (subject to certain limitations) from taxable income of gains recognized on the disposition of certain stock in qualifying corporations that has been held for at least five years. Although investors may ask for such a representation, companies may resist on the theory that the analysis regarding current compliance is complex, and that many elements of the test are outside the Company’s control. In any event, compliance with numerous other requirements during the time the investor holds the stock is needed for the investor to qualify for the benefits of Section 1202.

<sup>39</sup> There is no consensus position on what should be included in the “Disclosure” representation. Purchasers will generally try to obtain an unqualified representation that none of the written information and business plan information provided to them by the Company contains a material misstatement or a materially misleading omission. The Company will generally try to resist such a broad representation, on the basis that a 10b-5 type representation, commonly found in an IPO prospectus, is inappropriate for a private financing in which a prospectus-type due diligence process has not occurred. The language shown represents a compromise position. It is important to note that the investors’ right of recovery for a breach of this rep may be broader than under Rule SEC 10b-5, because in order to prevail in a Rule 10b-5 securities fraud action, the purchaser must establish that the seller acted with scienter. That is, a purely innocent misrepresentation normally does not give rise to civil liability under 10b-5. Another issue for a Series A investor to consider is the relative utility of this rep to the Series A investor at this stage, versus the risk of giving such a broad rep to investors in later rounds (who, in a worst case, may be looking for a rep on which to “hang their hat” if they decide they want out of the investment).

furnished or to be furnished to Purchasers at the Closing contains any untrue statement of a material fact or [, to the Company's knowledge,] omits to state a material fact necessary in order to make the statements contained herein or therein not misleading in light of the circumstances under which they were made. The Business Plan was prepared in good faith; however, the Company does not warrant that it will achieve any results projected in the Business Plan. It is understood that this representation is qualified by the fact that the Company has not delivered to the Purchasers, and has not been requested to deliver, a private placement or similar memorandum or any written disclosure of the types of information customarily furnished to purchasers of securities.

2.27 [Small Business Concern].<sup>40</sup> The Company together with its "affiliates" (as that term is defined in Section 121.103 of Title 13 of the Code of Federal Regulations ("CFR"), is a ["small business concern"] ["smaller business"] within the meaning of the Small Business Investment Act of 1958, as amended (the "**Small Business Act**"), and the regulations promulgated thereunder, including [Section 121.301 of Title 13 of the CFR] [Section 107.710 of Title 13 of the CFR]. The information delivered to each Purchaser that is a licensed Small Business Investment Company (an "**SBIC Purchaser**") on SBA Forms 480, 652 and 1031 delivered in connection herewith is true and complete. The Company is not ineligible for financing by any SBIC Purchaser pursuant to Section 107.720 of the CFR. The Company acknowledges that each SBIC Purchaser is a Federal licensee under the Small Business Act.]

2.28 [Foreign Corrupt Practices Act]. Neither the Company nor any of the Company's directors, officers, employees or agents have, directly or indirectly, made, offered, promised or authorized any payment or gift of any money or anything of value to or for the benefit of any "foreign official" (as such term is defined in the U.S. Foreign Corrupt Practices Act (the "**FCPA**")), foreign political party or official thereof or candidate for foreign political office for the purpose of (i) influencing any official act or decision of such official, party or candidate, (ii) inducing such official, party or candidate to use his, her or its influence to affect any act or decision of a foreign governmental authority or (iii) securing any improper advantage, in the case of (i), (ii) and (iii) above in order to assist the Company or any of its affiliates in obtaining or retaining business for or with, or directing business to, any person. Neither the Company nor any of its directors, officers, employees or agents have made or authorized any bribe, rebate, payoff, influence payment, kickback or other unlawful payment of funds or received or retained any funds in violation of any law, rule or regulation. The Company further represents that it has maintained, and has caused each of its subsidiaries and affiliates to maintain, systems of internal controls (including, but not limited to, accounting systems, purchasing systems and billing systems) to ensure compliance with the FCPA or any other applicable anti-bribery or anti-corruption law.]

2.29 [Data Privacy]. In connection with its collection, storage, transfer (including without limitation, any transfer across national borders) and/or use of any personally identifiable information from any individuals, including, without limitation, any customers,

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<sup>40</sup> The Small Business Concern representation is only necessary if one or more Purchasers is an SBIC.

prospective customers, employees and/or other third parties (collectively, “**Personal Information**”), the Company is and has been [,to the Company’s knowledge,] in compliance with all applicable laws in all relevant jurisdictions, the Company’s privacy policies, and the requirements of any contract or codes of conduct to which the Company is a party. The Company has commercially reasonable physical, technical, organizational and administrative security measures and policies in place to protect all Personal Information collected by it or on its behalf from and against unauthorized access, use and/or disclosure. The Company is and has been [,to the Company’s knowledge,] in compliance in all material respects with all laws relating to data loss, theft and breach of security notification obligations.]

[See ADDENDUM at end of this document with sample Founders Representations and Warranties.]<sup>41</sup>

3. Representations and Warranties of the Purchasers.<sup>42</sup> Each Purchaser hereby represents and warrants to the Company, severally and not jointly, that:

3.1 Authorization. The Purchaser has full power and authority to enter into the Transaction Agreements. The Transaction Agreements to which the Purchaser is a party, when executed and delivered by the Purchaser, will constitute valid and legally binding obligations of the Purchaser, enforceable in accordance with their terms, except (a) as limited by applicable bankruptcy, insolvency, reorganization, moratorium, fraudulent conveyance, and any other laws of general application affecting enforcement of creditors’ rights generally, and as limited by laws relating to the availability of specific performance, injunctive relief, or other equitable remedies, or (b) to the extent the indemnification provisions contained in the Investors’ Rights Agreement may be limited by applicable federal or state securities laws.

3.2 Purchase Entirely for Own Account.<sup>43</sup> This Agreement is made with the Purchaser in reliance upon the Purchaser’s representation to the Company, which by the Purchaser’s execution of this Agreement, the Purchaser hereby confirms, that the Shares to be acquired by the Purchaser will be acquired for investment for the Purchaser’s own account, not as a nominee or agent, and not with a view to the resale or distribution of any part thereof, and

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<sup>41</sup> Founders’ representations are controversial and may elicit significant resistance as they are found in a minority of venture deals. They are more likely to appear if Founders are receiving liquidity from the transaction, or if there is heightened concern over intellectual property (e.g., the Company is a spin-out from an academic institution or the Founder was formerly with another company whose business could be deemed competitive with the Company), or in international deals. Founders’ representations are even less common in subsequent rounds, where risk is viewed as significantly diminished and fairly shared by the investors, rather than being disproportionately borne by the Founders. A sample set of Founders Representations is attached as an Addendum at the end of this Model Stock Purchase Agreement.

<sup>42</sup> The main purpose of the Purchasers’ representations and warranties in Section 4 are to ensure that the investors meet the criteria for private placement exceptions under applicable state and federal securities laws.

<sup>43</sup> Occasionally, a venture capital fund will allow its employees and principals to co-invest through a special entity as nominee. Assuming these employees and principals meet the accreditation or sophistication standards necessary for the private placement exemption being relied on, and assuming the special purpose entity is not formed solely for the purpose of this investment, the language of this provision can be tailored to carve out that special entity.

that the Purchaser has no present intention of selling, granting any participation in, or otherwise distributing the same. By executing this Agreement, the Purchaser further represents that the Purchaser does not presently have any contract, undertaking, agreement or arrangement with any Person to sell, transfer or grant participations to such Person or to any third Person, with respect to any of the Shares. The Purchaser has not been formed for the specific purpose of acquiring the Shares.

3.3 Disclosure of Information. The Purchaser has had an opportunity to discuss the Company's business, management, financial affairs and the terms and conditions of the offering of the Shares with the Company's management and has had an opportunity to review the Company's facilities. The foregoing, however, does not limit or modify the representations and warranties of the Company in Section 2 of this Agreement or the right of the Purchasers to rely thereon.

3.4 Restricted Securities. The Purchaser understands that the Shares have not been, and will not be, registered under the Securities Act, by reason of a specific exemption from the registration provisions of the Securities Act which depends upon, among other things, the bona fide nature of the investment intent and the accuracy of the Purchaser's representations as expressed herein. The Purchaser understands that the Shares are "restricted securities" under applicable U.S. federal and state securities laws and that, pursuant to these laws, the Purchaser must hold the Shares indefinitely unless they are registered with the Securities and Exchange Commission and qualified by state authorities, or an exemption from such registration and qualification requirements is available. The Purchaser acknowledges that the Company has no obligation to register or qualify the Shares, or the Common Stock into which it may be converted, for resale except as set forth in the Investors' Rights Agreement. The Purchaser further acknowledges that if an exemption from registration or qualification is available, it may be conditioned on various requirements including, but not limited to, the time and manner of sale, the holding period for the Shares, and on requirements relating to the Company which are outside of the Purchaser's control, and which the Company is under no obligation and may not be able to satisfy. [The Purchaser acknowledges that the Company filed a registration statement for a public offering of its Common Stock, which was withdrawn effective [\_\_\_\_\_, 20\_\_]. The Purchaser understands that this offering is not intended to be part of the public offering, and that the Purchaser will not be able to rely on the protection of Section 11 of the Securities Act.<sup>44</sup>]

3.5 No Public Market. The Purchaser understands that no public market now exists for the Shares, and that the Company has made no assurances that a public market will ever exist for the Shares.

3.6 Legends. The Purchaser understands that the Shares and any securities issued in respect of or exchange for the Shares, may bear one or all of the following legends:

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<sup>44</sup> Include the bracketed language if the private placement exemption is based on the safe harbor in Rule 155(c) under the Securities Act for private offerings following an abandoned public offering.

(a) “THE SHARES REPRESENTED BY THIS CERTIFICATE HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AND HAVE BEEN ACQUIRED FOR INVESTMENT AND NOT WITH A VIEW TO, OR IN CONNECTION WITH, THE SALE OR DISTRIBUTION THEREOF. NO SUCH TRANSFER MAY BE EFFECTED WITHOUT AN EFFECTIVE REGISTRATION STATEMENT RELATED THERETO OR AN OPINION OF COUNSEL IN A FORM SATISFACTORY TO THE COMPANY THAT SUCH REGISTRATION IS NOT REQUIRED UNDER THE SECURITIES ACT OF 1933.”

(b) Any legend set forth in, or required by, the other Transaction Agreements.

(c) Any legend required by the securities laws of any state to the extent such laws are applicable to the Shares represented by the certificate so legended.

3.7 Accredited Investor. The Purchaser is an accredited investor as defined in Rule 501(a) of Regulation D promulgated under the Securities Act.

3.8 Foreign Investors. If the Purchaser is not a United States person (as defined by Section 7701(a)(30) of the Code), the Purchaser hereby represents that it has satisfied itself as to the full observance of the laws of its jurisdiction in connection with any invitation to subscribe for the Shares or any use of this Agreement, including (i) the legal requirements within its jurisdiction for the purchase of the Shares, (ii) any foreign exchange restrictions applicable to such purchase, (iii) any governmental or other consents that may need to be obtained, and (iv) the income tax and other tax consequences, if any, that may be relevant to the purchase, holding, redemption, sale, or transfer of the Shares. The Purchaser’s subscription and payment for and continued beneficial ownership of the Shares will not violate any applicable securities or other laws of the Purchaser’s jurisdiction.

3.9 No General Solicitation. Neither the Purchaser, nor any of its officers, directors, employees, agents, stockholders or partners has either directly or indirectly, including through a broker or finder (a) engaged in any general solicitation, or (b) published any advertisement in connection with the offer and sale of the Shares.<sup>45</sup>

3.10 Exculpation Among Purchasers. The Purchaser acknowledges that it is not relying upon any Person, other than the Company and its officers and directors, in making its investment or decision to invest in the Company. [The Purchaser agrees that neither any Purchaser nor the respective controlling Persons, officers, directors, partners, agents, or

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<sup>45</sup> In September 2012 and pursuant to the Jumpstart Our Business Startups Act (the “JOBS Act”), the SEC proposed new rules amending Rule 506 of Regulation D and Rule 144A which would provide that the Rule 502(c) prohibition against general solicitation and general advertising would not apply to offers and sales of securities made pursuant to Rule 506 where all purchasers of the securities are accredited investors. Until these rules are finalized, any disclosures made under Section 3.9 in reliance on the JOBS Act should be carefully scrutinized by counsel.



employees of any Purchaser shall be liable to any other Purchaser for any action heretofore taken or omitted to be taken by any of them in connection with the purchase of the Shares.]<sup>46</sup>

3.11 Residence. If the Purchaser is an individual, then the Purchaser resides in the state or province identified in the address of the Purchaser set forth on Exhibit A; if the Purchaser is a partnership, corporation, limited liability company or other entity, then the office or offices of the Purchaser in which its principal place of business is identified in the address or addresses of the Purchaser set forth on Exhibit A.

3.12 [Consent to Promissory Note Conversion and Termination. Each Purchaser, to the extent that such Purchaser, as set forth on the Schedule of Purchasers, is a holder of any promissory note of the Company being converted and/or cancelled in consideration of the issuance hereunder of Shares to such Purchaser, hereby agrees that the entire amount owed to such Purchaser under such note is being tendered to the Company in exchange for the applicable Shares set forth on the Schedule of Purchasers, and effective upon the Company's and such Purchaser's execution and delivery of this Agreement, without any further action required by the Company or such Purchaser, such note and all obligations set forth therein shall be immediately deemed repaid in full and terminated in their entirety, including, but not limited to, any security interest effected therein.<sup>47</sup>]

4. Conditions to the Purchasers' Obligations at Closing.<sup>48</sup> The obligations of each Purchaser to purchase Shares at the Initial Closing [or any subsequent Closing] are subject to the

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<sup>46</sup> This provision is intended to protect the lead investor from claims of reliance by other investors.

<sup>47</sup> This eliminates any issues resulting from possible miscalculation of the amount owed to investor noteholders (miscalculations that can result from, for example, application of conversion discounts).

<sup>48</sup> Section 5 contains the conditions which the Company must satisfy (or which must be waived) prior to closing in order to trigger the investors' obligation to purchase the shares; Section 5 contains the conditions the investors must satisfy to trigger the Company's obligation to sell the shares. With respect to each side, the essential requirements are (A) that all of the representations and warranties each makes in the Agreement are still true at the closing and (B) that the other parties have entered into the other Transaction Agreements. If (as is typically the case) the Agreement contemplates a simultaneous signing and closing, consider deleting Subsections 4.1-4.4, 4.6, 4.13, 4.14 and 4.17(which, for the most part, can be covered by the representations in Section 2), and recasting the subsections of Section 5 as closing deliveries. If the Agreement contemplates multiple closings, attention should be given to determining what conditions must be satisfied in order to trigger the investors' obligations to purchase shares at subsequent closings.

Subsections 4.3 and 4.5 specifically require the Company to deliver at the Closing a Compliance Certificate and opinion of Company Counsel. In addition, it is generally necessary to deliver at the Closing (A) a Secretary's certificate certifying the Company's bylaws, board resolutions approving the transaction, and stockholder resolutions approving the Restated Certificate (B) good standing certificates from the Secretary of State (C) the certified Restated Certificate, and (D) waivers of any rights of first refusal triggered by the financing. These documents are therefore listed as "Closing Documents" on transaction checklists even though they are not specifically required to be delivered by the Agreement and are technically covered by the Compliance Certificate and the opinion of the Company's counsel. If the transaction is structured as a simultaneous signing and closing, the closing conditions serve as a convenient closing checklist, but are significantly diminished in importance.

If there are to be subsequent closings, consider whether all of the closing conditions applicable to the Initial Closing should be applicable to the subsequent closing. It may be appropriate to include a separate, more limited set of closing conditions for a subsequent closing.

fulfillment, on or before such Closing, of each of the following conditions, unless otherwise waived:

4.1 Representations and Warranties. The representations and warranties of the Company contained in Section 2 [and the representations and warranties of the Founders in Section 0] shall be true and correct in all respects as of such Closing.

4.2 Performance. The Company shall have performed and complied with all covenants, agreements, obligations and conditions contained in this Agreement that are required to be performed or complied with by the Company on or before such Closing.

4.3 Compliance Certificate. The President of the Company shall deliver to the Purchasers at such Closing a certificate certifying that the conditions specified in Subsections 4.1 and 4.2 have been fulfilled.

4.4 Qualifications. All authorizations, approvals or permits, if any, of any governmental authority or regulatory body of the United States or of any state that are required in connection with the lawful issuance and sale of the Shares pursuant to this Agreement shall be obtained and effective as of such Closing.

4.5 Opinion of Company Counsel. The Purchasers shall have received from [\_\_\_\_\_], counsel for the Company, an opinion, dated as of the Initial Closing, in substantially the form of Exhibit I attached to this Agreement.

4.6 Board of Directors. As of the Initial Closing, the authorized size of the Board shall be [\_\_\_\_\_], and the Board shall be comprised of [\_\_\_\_\_].<sup>49</sup>

4.7 Indemnification Agreement. The Company shall have executed and delivered the Indemnification Agreements.

4.8 Investors' Rights Agreement. The Company and each Purchaser (other than the Purchaser relying upon this condition to excuse such Purchaser's performance hereunder)[ and the other stockholders of the Company named as parties thereto] shall have executed and delivered the Investors' Rights Agreement.

4.9 Right of First Refusal and Co-Sale Agreement. The Company, each Purchaser (other than the Purchaser relying upon this condition to excuse such Purchaser's performance hereunder), and the other stockholders of the Company named as parties thereto shall have executed and delivered the Right of First Refusal and Co-Sale Agreement.

4.10 Voting Agreement. The Company, each Purchaser (other than the Purchaser relying upon this condition to excuse such Purchaser's performance hereunder), and

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<sup>49</sup> If this section is used, the Company must take the actions necessary to elect the agreed-upon Board of Directors.

the other stockholders of the Company named as parties thereto shall have executed and delivered the Voting Agreement.

4.11 Restated Certificate. The Company shall have filed the Restated Certificate with the Secretary of State of Delaware on or prior to the Closing, which shall continue to be in full force and effect as of the Closing.

4.12 Secretary's Certificate. The Secretary of the Company shall have delivered to the Purchasers at the Closing a certificate certifying (i) the Bylaws of the Company, (ii) resolutions of the Board of Directors of the Company approving the Transaction Agreements and the transactions contemplated under the Transaction Agreements, and (iii) resolutions of the stockholders of the Company approving the Restated Certificate.

4.13 Proceedings and Documents. All corporate and other proceedings in connection with the transactions contemplated at the Closing and all documents incident thereto shall be reasonably satisfactory in form and substance to each Purchaser, and each Purchaser (or its counsel) shall have received all such counterpart original and certified or other copies of such documents as reasonably requested. Such documents may include good standing certificates.

4.14 Minimum Number of Shares at Initial Closing. A minimum of [ \_\_\_\_\_ ] Shares must be sold at the Initial Closing.<sup>50</sup>

4.15 Management Rights.<sup>51</sup> A Management Rights Letter shall have been executed by the Company and delivered to each Purchaser to whom it is addressed.

4.16 [SBA Matters. The Company shall have executed and delivered to each SBIC Purchaser a Size Status Declaration on SBA Form 280 and an Assurance of Compliance on SBA Form 652, and shall have provided to each such Purchaser information necessary for the preparation of a Portfolio Financing Report on SBA Form 1031.]

4.17 [Preemptive Rights. The Company shall have fully satisfied (including with respect to rights of timely notification) or obtained enforceable waivers in respect of any preemptive or similar rights directly or indirectly affecting any of its securities.<sup>52</sup>]

5. Conditions of the Company's Obligations at Closing. The obligations of the Company to sell Shares to the Purchasers at the Initial Closing [or any subsequent Closing] are subject to the fulfillment, on or before the Closing, of each of the following conditions, unless otherwise waived:

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<sup>50</sup> Sometimes the term sheet will specify that a minimum number of Shares must be sold at the Initial Closing.

<sup>51</sup> See explanatory commentary in introduction to model Management Rights Letter.

<sup>52</sup> Usually only necessary at a later round of financing, when there are existing preemptive rights holders.

5.1 Representations and Warranties. The representations and warranties of each Purchaser contained in Subsection 4.1 shall be true and correct in all respects as of such Closing.

5.2 Performance. The Purchasers shall have performed and complied with all covenants, agreements, obligations and conditions contained in this Agreement that are required to be performed or complied with by them on or before such Closing.

5.3 Qualifications. All authorizations, approvals or permits, if any, of any governmental authority or regulatory body of the United States or of any state that are required in connection with the lawful issuance and sale of the Shares pursuant to this Agreement shall be obtained and effective as of the Closing.

5.4 Investors' Rights Agreement. Each Purchaser shall have executed and delivered the Investors' Rights Agreement.

5.5 Right of First Refusal and Co-Sale Agreement. Each Purchaser and the other stockholders of the Company named as parties thereto shall have executed and delivered the Right of First Refusal and Co-Sale Agreement.

5.6 Voting Agreement. Each Purchaser and the other stockholders of the Company named as parties thereto shall have executed and delivered the Voting Agreement.

5.7 [Minimum Number of Shares at Initial Closing. A minimum of [\_\_\_\_\_] Shares must be sold at the Initial Closing.]

## 6. Miscellaneous.

6.1 Survival of Warranties. Unless otherwise set forth in this Agreement, the representations and warranties of the Company [, the Founders] and the Purchasers contained in or made pursuant to this Agreement shall survive the execution and delivery of this Agreement and the Closing and shall in no way be affected by any investigation or knowledge of the subject matter thereof made by or on behalf of the Purchasers or the Company.<sup>53</sup>

6.2 Successors and Assigns. The terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective successors and assigns of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and assigns any rights, remedies, obligations, or liabilities under or by reason of this Agreement, except as expressly provided in this Agreement.

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<sup>53</sup> Sometimes a limited survival period is negotiated.

6.3 Governing Law. This Agreement shall be governed by the internal law of [the State of Delaware].<sup>54</sup>

6.4 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. Counterparts may be delivered via facsimile, electronic mail (including pdf) or other transmission method and any counterpart so delivered shall be deemed to have been duly and validly delivered and be valid and effective for all purposes.

6.5 Titles and Subtitles. The titles and subtitles used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

6.6 Notices. All notices and other communications given or made pursuant to this Agreement shall be in writing and shall be deemed effectively given upon the earlier of actual receipt or: (a) personal delivery to the party to be notified, (b) when sent, if sent by electronic mail or facsimile during normal business hours of the recipient, and if not sent during normal business hours, then on the recipient's next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) business day after deposit with a nationally recognized overnight courier, freight prepaid, specifying next business day delivery, with written verification of receipt. All communications shall be sent to the respective parties at their address as set forth on the signature page or Exhibit A, or to such e-mail address, facsimile number or address as subsequently modified by written notice given in accordance with this Subsection 6.6. If notice is given to the Company, a copy shall also be sent to [*Company Counsel Name and Address*] and if notice is given to the Purchasers, a copy shall also be given to [*Purchaser Counsel Name and Address*].

6.7 No Finder's Fees.<sup>55</sup> Each party represents that it neither is nor will be obligated for any finder's fee or commission in connection with this transaction. Each Purchaser agrees to indemnify and to hold harmless the Company from any liability for any commission or compensation in the nature of a finder's or broker's fee arising out of this transaction (and the costs and expenses of defending against such liability or asserted liability) for which each Purchaser or any of its officers, employees, or representatives is responsible. The Company agrees to indemnify and hold harmless each Purchaser from any liability for any commission or

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<sup>54</sup> Some practitioners may select Delaware law as it has historically been the richest source for corporation law precedent. Other practitioners will prefer to choose the (non-Delaware) jurisdiction in which they are admitted to practice, if for no other reason than not having to retain Delaware counsel in the event they are called upon to give an enforceability opinion. In *Abry Partners V v. F&W Acquisition LLC, Case No. C.A. 1756-N (Del Ch. Ct. 2/14/06)*, the Delaware Chancery Court stated that it would respect a Delaware choice of law provision so long as Delaware law has a material relationship to the transaction – which will very often be the case in venture financings (e.g., parties are Delaware corporation, LLPs, or LLCs). However, it should be noted that if an action is brought in a jurisdiction other than the state whose governing law has been selected, that jurisdiction will apply its own choice of law principles in deciding whether or not to give effect to the governing law selected by the parties. Further, under the internal affairs doctrine of the state whose law is chosen to govern the agreement, whether or not the parties so provide, the DGCL will apply to certain provisions (e.g. voting of shares of stock).

<sup>55</sup> This provision may need to be modified to fit the facts of a particular transaction.

compensation in the nature of a finder's or broker's fee arising out of this transaction (and the costs and expenses of defending against such liability or asserted liability) for which the Company or any of its officers, employees or representatives is responsible.

6.8 Fees and Expenses. At the Closing, the Company shall pay the reasonable fees and expenses of [\_\_\_\_], the counsel for [name of lead Purchaser<sup>56</sup>], in an amount not to exceed, in the aggregate, \$[\_\_\_\_\_].

6.9 [Attorneys' Fees. If any action at law or in equity (including arbitration) is necessary to enforce or interpret the terms of any of the Transaction Agreements, the prevailing party shall be entitled to reasonable attorneys' fees, costs and necessary disbursements in addition to any other relief to which such party may be entitled.]

6.10 Amendments and Waivers.<sup>57</sup> Except as set forth in Subsection 1.3 of this Agreement, any term of this Agreement may be amended, terminated or waived only with the written consent of the Company and (i) the holders of at least [*specify percentage*] of the then-outstanding Shares or (ii) for an amendment, termination or waiver effected prior to the Initial Closing, Purchasers obligated to purchase [*specify percentage*] of the Shares to be issued at the Initial Closing. Any amendment or waiver effected in accordance with this Subsection 6.10 shall be binding upon the Purchasers and each transferee of the Shares (or the Common Stock issuable upon conversion thereof), each future holder of all such securities, and the Company.

6.11 Severability. The invalidity or unenforceability of any provision hereof shall in no way affect the validity or enforceability of any other provision.

6.12 Delays or Omissions. No delay or omission to exercise any right, power or remedy accruing to any party under this Agreement, upon any breach or default of any other party under this Agreement, shall impair any such right, power or remedy of such non-breaching or non-defaulting party nor shall it be construed to be a waiver of any such breach or default, or an acquiescence therein, or of or in any similar breach or default thereafter occurring; nor shall any waiver of any single breach or default be deemed a waiver of any other breach or default theretofore or thereafter occurring. Any waiver, permit, consent or approval of any kind or character on the part of any party of any breach or default under this Agreement, or any waiver on the part of any party of any provisions or conditions of this Agreement, must be in writing and shall be effective only to the extent specifically set forth in such writing. All remedies, either under this Agreement or by law or otherwise afforded to any party, shall be cumulative and not alternative.

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<sup>56</sup> Typically, only the lead Purchaser is actually represented by counsel, with the other Purchasers relying on the lead Purchaser's having conducted due diligence and hired legal counsel. Occasionally, counsel will represent the Purchasers as a group, or one or more of the other Purchasers will have separate counsel, in which case this provision will need to be tailored accordingly.

<sup>57</sup> This provision may need to be tailored if there are to be Milestone Closings to permit or prevent, as appropriate, a majority from waiving or changing the agreed-upon milestones and related conditions. In addition, if Founder's representations are included, this provision may need to give the Founder protection against adverse amendments.

6.13 Entire Agreement. This Agreement (including the Exhibits hereto), the Restated Certificate and the other Transaction Agreements constitute the full and entire understanding and agreement between the parties with respect to the subject matter hereof, and any other written or oral agreement relating to the subject matter hereof existing between the parties are expressly canceled.

6.14 [Corporate Securities Law.<sup>58</sup> THE SALE OF THE SECURITIES WHICH ARE THE SUBJECT OF THIS AGREEMENT HAS NOT BEEN QUALIFIED WITH THE COMMISSIONER OF CORPORATIONS OF THE STATE OF CALIFORNIA AND THE ISSUANCE OF THE SECURITIES OR THE PAYMENT OR RECEIPT OF ANY PART OF THE CONSIDERATION THEREFOR PRIOR TO THE QUALIFICATION IS UNLAWFUL, UNLESS THE SALE OF SECURITIES IS EXEMPT FROM THE QUALIFICATION BY SECTION 25100, 25102 OR 25105 OF THE CALIFORNIA CORPORATIONS CODE. THE RIGHTS OF ALL PARTIES TO THIS AGREEMENT ARE EXPRESSLY CONDITIONED UPON THE QUALIFICATION BEING OBTAINED UNLESS THE SALE IS SO EXEMPT.]

6.15 Dispute Resolution.<sup>59</sup> The parties (a) hereby irrevocably and unconditionally submit to the jurisdiction of the state courts of [*state*] and to the jurisdiction of the United States District Court for the District of [*judicial district*] for the purpose of any suit, action or other proceeding arising out of or based upon this Agreement, (b) agree not to commence any suit, action or other proceeding arising out of or based upon this Agreement except in the state courts of [*state*] or the United States District Court for the District of [*judicial district*], and (c) hereby waive, and agree not to assert, by way of motion, as a defense, or otherwise, in any such suit, action or proceeding, any claim that it is not subject personally to the jurisdiction of the above-named courts, that its property is exempt or immune from attachment or execution, that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that this Agreement or the subject matter hereof may not be enforced in or by such court.

WAIVER OF JURY TRIAL: EACH PARTY HEREBY WAIVES ITS RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT, THE OTHER TRANSACTION DOCUMENTS, THE SECURITIES OR THE SUBJECT MATTER HEREOF OR THEREOF. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL-ENCOMPASSING OF ANY AND ALL DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS

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<sup>58</sup> Subsection 6.14 is to be used for transactions governed by California law that are not relying on NSMIA for a state securities law exemption.

<sup>59</sup> In the prior version of the NVCA Model Documents it was noted that in 2009 Delaware enacted legislation permitting confidential arbitration of disputes before a sitting Delaware Chancery Court Chancellor so long as 1) at least one party is a Delaware business entity or has its principal place of business in Delaware and 2) there is at least \$1 million in controversy. However, in August 2012 the U.S. District Court for the District of Delaware held in *Delaware Coalition for Open Government v. Strine* (D. Del. Aug. 30, 2012) that such confidential arbitration violates the First Amendment's right of access to civil trials. For so long as this decision stands (the State of Delaware reportedly plans to appeal), it seems imprudent to include a provision stipulating that disputes are to be arbitrated in the Delaware Court of Chancery.

TRANSACTION, INCLUDING, WITHOUT LIMITATION, CONTRACT CLAIMS, TORT CLAIMS (INCLUDING NEGLIGENCE), BREACH OF DUTY CLAIMS, AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. THIS SECTION HAS BEEN FULLY DISCUSSED BY EACH OF THE PARTIES HERETO AND THESE PROVISIONS WILL NOT BE SUBJECT TO ANY EXCEPTIONS. EACH PARTY HERETO HEREBY FURTHER WARRANTS AND REPRESENTS THAT SUCH PARTY HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT SUCH PARTY KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL

[*Alternative*: Any unresolved controversy or claim arising out of or relating to this Agreement, except as (i) otherwise provided in this Agreement, or (ii) any such controversies or claims arising out of either party's intellectual property rights for which a provisional remedy or equitable relief is sought, shall be submitted to arbitration by one arbitrator mutually agreed upon by the parties, and if no agreement can be reached within thirty (30) days after names of potential arbitrators have been proposed by the American Arbitration Association (the "AAA"), then by one arbitrator having reasonable experience in corporate finance transactions of the type provided for in this Agreement and who is chosen by the AAA. The arbitration shall take place in [*location*], in accordance with the AAA rules then in effect, and judgment upon any award rendered in such arbitration will be binding and may be entered in any court having jurisdiction thereof. There shall be limited discovery prior to the arbitration hearing as follows: (a) exchange of witness lists and copies of documentary evidence and documents relating to or arising out of the issues to be arbitrated, (b) depositions of all party witnesses and (c) such other depositions as may be allowed by the arbitrators upon a showing of good cause. Depositions shall be conducted in accordance with the [*State*] Code of Civil Procedure, the arbitrator shall be required to provide in writing to the parties the basis for the award or order of such arbitrator, and a court reporter shall record all hearings, with such record constituting the official transcript of such proceedings.

[Each party will bear its own costs in respect of any disputes arising under this Agreement.] [The prevailing party shall be entitled to reasonable attorney's fees, costs, and necessary disbursements in addition to any other relief to which such party may be entitled.] Each of the parties to this Agreement consents to personal jurisdiction for any equitable action sought in the U.S. District Court for the District of [\_\_\_\_\_] or any court of the [*State*][*Commonwealth*] of [*state*] having subject matter jurisdiction.]

6.16 [No Commitment for Additional Financing]. The Company acknowledges and agrees that no Purchaser has made any representation, undertaking, commitment or agreement to provide or assist the Company in obtaining any financing, investment or other assistance, other than the purchase of the Shares as set forth herein and subject to the conditions set forth herein. In addition, the Company acknowledges and agrees that (i) no statements, whether written or oral, made by any Purchaser or its representatives on or after the date of this Agreement shall create an obligation, commitment or agreement to provide or assist the Company in obtaining any financing or investment, (ii) the Company shall not rely on any such statement by any Purchaser or its representatives and (iii) an obligation, commitment or agreement to provide or assist the Company in obtaining any financing or investment may only be created by a written agreement, signed by such Purchaser and the Company, setting forth the



terms and conditions of such financing or investment and stating that the parties intend for such writing to be a binding obligation or agreement. Each Purchaser shall have the right, in its sole and absolute discretion, to refuse or decline to participate in any other financing of or investment in the Company, and shall have no obligation to assist or cooperate with the Company in obtaining any financing, investment or other assistance.]

6.17 [Waiver of Conflicts]. Each party to this Agreement acknowledges that [insert name of Company Counsel], counsel for the Company, has in the past performed and may continue to perform legal services for certain of the Purchasers in matters unrelated to the transactions described in this Agreement, including the representation of such Purchasers in venture capital financings and other matters. Accordingly, each party to this Agreement hereby (a) acknowledges that they have had an opportunity to ask for information relevant to this disclosure; and (b) gives its informed consent to [insert name of Company Counsel]'s representation of certain of the Purchasers in such unrelated matters and to [insert name of Company Counsel]'s representation of the Company in connection with this Agreement and the transactions contemplated hereby.]

IN WITNESS WHEREOF, the parties have executed this Series A Preferred Stock Purchase Agreement as of the date first written above.

COMPANY:

By: \_\_\_\_\_

Name: \_\_\_\_\_  
(print)

Title: \_\_\_\_\_

Address:

[FOUNDERS:

\_\_\_\_\_  
Signature

Name: \_\_\_\_\_  
(print)

Address:

]

PURCHASERS:

\_\_\_\_\_  
(Print Name of Purchaser)

By: \_\_\_\_\_

Name: \_\_\_\_\_  
(print)

Title: \_\_\_\_\_

Address:

## EXHIBITS

- Exhibit A - **SCHEDULE OF PURCHASERS**
- Exhibit B - **FORM OF AMENDED AND RESTATED  
CERTIFICATE OF INCORPORATION**
- Exhibit C - **DISCLOSURE SCHEDULE**
- Exhibit D - **FORM OF INDEMNIFICATION AGREEMENT**
- Exhibit E - **FORM OF INVESTORS' RIGHTS AGREEMENT**
- Exhibit F - **FORM OF MANAGEMENT RIGHTS LETTER**
- Exhibit G - **FORM OF RIGHT OF FIRST REFUSAL AND CO-  
SALE AGREEMENT**
- Exhibit H - **FORM OF VOTING AGREEMENT**
- Exhibit I - **FORM OF LEGAL OPINION OF [COMPANY COUNSEL]**
- [Exhibit J - **MILESTONE EVENTS]**

EXHIBIT A

**SCHEDULE OF PURCHASERS**

EXHIBIT B

**FORM OF AMENDED AND RESTATED  
CERTIFICATE OF INCORPORATION**

EXHIBIT C

**DISCLOSURE SCHEDULE**

EXHIBIT D

**FORM OF INDEMNIFICATION AGREEMENT**



EXHIBIT E

**FORM OF INVESTORS' RIGHTS AGREEMENT**

EXHIBIT F

**FORM OF MANAGEMENT RIGHTS LETTER**

EXHIBIT G

**FORM OF RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT**

EXHIBIT H

**FORM OF VOTING AGREEMENT**

EXHIBIT I

**FORM OF LEGAL OPINION OF [COMPANY COUNSEL]**

[EXHIBIT J

**MILESTONE EVENTS]**

## **ADDENDUM TO STOCK PURCHASE AGREEMENT: SAMPLE FOUNDER REPRESENTATIONS AND WARRANTIES**

[3. Representations and Warranties of the Founders. Except as set forth on the Disclosure Schedule, each of the Founders, severally and not jointly, represents and warrants to each Purchaser as of the date of the Closing at which such Purchaser is purchasing Shares as follows [(it being understood and agreed that any Founder's liability for breaches of any provisions of this Section 3 shall be limited to the then current fair market value [as determined in good faith by the board of directors of the Company] of the shares of Common Stock of the Company currently owned by such Founder and such Founder [may, in his sole discretion, discharge such liability by the surrender of such shares or the payment of cash]<sup>60</sup> [shall discharge such liability by the surrender of such shares] and will terminate on the earlier of (i) [one year/two years] after the date of this Agreement, or (ii) the completion of an initial public offering of the Company's Common Stock)]:

3.1 Conflicting Agreements. Such Founder is not, as a result of the nature of the business conducted or currently proposed to be conducted by the Company or for any other reason, in violation of (i) any fiduciary or confidential relationship, (ii) any term of any contract or covenant (either with the Company or with another entity) relating to employment, patents, assignment of inventions, confidentiality, proprietary information disclosure, non-competition or non-solicitation, or (iii) any other contract or agreement, or any judgment, decree or order of any court or administrative agency binding on the Founder and relating to or affecting the right of such Founder to be employed by or serve as a director or consultant to the Company. No such relationship, term, contact, agreement, judgment, decree or order conflict with such Founder's obligations to use his best efforts to promote the interests of the Company nor does the execution and delivery of this Agreement, nor such Founder's carrying on the Company's business as a director, officer, consultant or Key Employee of the Company, conflict with any such relationship, term, contract, agreement, judgment, decree or order.

3.2 Litigation. There is no action, suit or proceeding, or governmental inquiry or investigation, pending or, to such Founder's knowledge, threatened against such Founder, and, to such Founder's knowledge, there is no basis for any such action, suit, proceeding, or governmental inquiry or investigation that would result in a Material Adverse Effect.

3.3 Stockholder Agreements. Except as contemplated by or disclosed in the Transaction Agreements, such Founder is not a party to and has no knowledge of any agreements, written or oral, relating to the acquisition, disposition, registration under the Securities Act, or voting of the securities of the Company.

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<sup>60</sup> Investors should consider whether cash is an acceptable remedy; the cash value of the shares is likely to be low, particularly if there has been a breach of a rep or warranty. In addition, if the Investors require the surrender of shares rather than cash, they should also consider whether to include Preferred Stock, as well, if the Founder owns shares of Preferred.

3.4 Representations and Warranties. [To such Founder's knowledge,] all of the representations and warranties of the Company set forth in Section 2 are true and complete.

3.5 Prior Legal Matters. Such Founder has not been (a) subject to voluntary or involuntary petition under the federal bankruptcy laws or any state insolvency law or the appointment of a receiver, fiscal agent or similar officer by a court for his business or property; (b) convicted in a criminal proceeding or named as a subject of a pending criminal proceeding (excluding traffic violations and other minor offenses); (c) subject to any order, judgment, or decree (not subsequently reversed, suspended, or vacated) of any court of competent jurisdiction permanently or temporarily enjoining him from engaging, or otherwise imposing limits or conditions on his engagement in any securities, investment advisory, banking, insurance, or other type of business or acting as an officer or director of a public company; or (d) found by a court of competent jurisdiction in a civil action or by the Securities and Exchange Commission or the Commodity Futures Trading Commission to have violated any federal or state securities, commodities or unfair trade practices law, which such judgment or finding has not been subsequently reversed, suspended, or vacated.]



**This sample document is the work product of a coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample presents an array of (often mutually exclusive) options with respect to particular deal provisions.**

**AMENDED AND RESTATED  
CERTIFICATE OF INCORPORATION**

## ***Preliminary Notes***

### *General.*

*The Certificate of Incorporation is a key document produced in connection with a venture capital portfolio investment. Among other things, the Corporation's Certificate of Incorporation establishes the rights, preferences, privileges and restrictions of each class and series of the Corporation's stock.*

### *No Impairment Clause.*

*It is not uncommon for counsel to the investors to include a "no impairment" clause in their Certificate of Incorporation drafts. A "no impairment" clause is a broad and general provision that prohibits the Corporation from acting (or failing to act) in a way that would circumvent the express and specific provisions of the Certificate of Incorporation. Although Delaware courts narrowly construe "no impairment" clauses<sup>1</sup>, such provisions can be dangerous, both to the Corporation and to the controlling investors, because they can give rise to claims of violation by disgruntled minority investors looking for some grounds on which to base a claim, in the absence of any specific protective provisions in the Certificate of Incorporation. In addition, in a transaction in which the terms of the outstanding Preferred Stock are to be amended, specifically the anti-dilution and conversion rights, certain law firms have taken the position that the existence of a "no impairment" clause in the Certificate of Incorporation requires their firm to express no opinion with regard to the stockholder action taken in connection with the subject transaction, and instead assume for purposes of their opinion that the Corporation has complied with the provisions of the "no impairment" clause. If appropriate attention is paid to the specific, substantive provisions of the Certificate of Incorporation, there is no need for a vague catch-all which may give rise to the problems described above. Accordingly, the drafters intentionally did not include a "no impairment" clause in this Certificate of Incorporation.*

### *Pay-to-Play Provision.*

*This Certificate of Incorporation includes a sample "pay-to-play" provision, pursuant to which Preferred Stock investors are penalized if they fail to invest to a specified extent in certain future rounds of financing. The provision included herein provides for conversion into Common Stock of some or all of the Series A Preferred Stock held by non-participating investors. An alternative provision which provides for conversion of some or all of the Series A Preferred Stock held by non-participating investors into a new series of Preferred Stock (e.g., Series A-1 Preferred Stock) identical to the Series A Preferred Stock but with no anti-dilution protection and no further pay-to-play provision is also sometimes used. It is the drafters' view that this latter provision is not seen very frequently and therefore it has been intentionally omitted from this Certificate of Incorporation. In the event such a provision is used, careful attention should be paid to the mechanics of implementing the creation of the additional series of Preferred Stock, which may include the authorization of blank check preferred (as described below).*

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<sup>1</sup> See *Kumar v. Racing Corp. of Am., Inc.*, Case No. C.A. 12039 (Del. Ch. Ct. 4/26/91).

### Blank Check Preferred.

*Blank check preferred is the term used when the Certificate of Incorporation authorizes shares of undesignated Preferred Stock and grants the Board of Directors the authority to create a new series of Preferred Stock and establish the rights and preferences of such series. Without this express grant of authority to the Board, the Corporation would need to obtain stockholder approval to amend the Certificate of Incorporation to create a new series of Preferred Stock. The drafters view the inclusion of blank check preferred in a Certificate of Incorporation for a venture backed company as unusual. It is sometimes seen, if (as noted above under “Pay-to-Play Provision”) the Series A Preferred Stock terms include a pay-to-play provision in which the Series A Preferred Stock of non-participating investors is converted into a shadow series of Series A Preferred Stock, in which case it can be desirable to include blank check preferred to facilitate the creation (if necessary) of such shadow series. Even in those circumstances, however, Section 3 of the Series A Preferred Stock terms often includes restrictions on the designation or issuance of blank check preferred.*

*Accordingly, this Certificate of Incorporation assumes that blank check preferred will not be used and the drafters intentionally did not include a provision authorizing blank check preferred. In the event blank check preferred is to be included in the Certificate of Incorporation, appropriate references to other potential series of Preferred Stock should be included in the Series A Preferred Stock terms so as to permit the Corporation to create another series of Preferred Stock by means of a Certificate of Designations without having to revise the terms of the Series A Preferred Stock (which can only be done by a Certificate of Amendment, approved by stockholders, and not by a Certificate of Designations). In addition, in the event provision is to be made for blank check preferred, appropriate consideration should also be given to building in references to such other potential series of Preferred Stock in the contractual agreements providing for additional rights and obligations of the holders of Series A Preferred Stock (such as the Investors’ Rights Agreement, Right of First Refusal and Co-Sale Agreement and Voting Agreement).*

### Choice of Jurisdiction.

*This form is set up for a portfolio company incorporated in Delaware. Delaware is generally the preferred jurisdiction for incorporation of venture-backed companies for many reasons, including:*

- 1. the Delaware General Corporation Law (the “DGCL”) is a modern, current and internationally recognized and copied corporation statute which is updated annually to take into account new business and court developments;*
- 2. Delaware offers a well-developed body of case law interpreting the DGCL, which facilitates certainty in business planning;*
- 3. the Delaware Court of Chancery is considered by many to be the nation’s leading business court, where judges expert in business law matters deal with business issues in an impartial setting; and*
- 4. Delaware offers an efficient and user-friendly Secretary of State’s office permitting, among other things, prompt certification of filings of corporate documents.*

Please note the following special considerations if the Corporation is located in California, even though incorporated in Delaware:

Considerations for Corporation with California Shareholders and Operations.

Section 2115 of the California Corporations Code provides that certain provisions of California corporate law are applicable to foreign corporations (e.g., one incorporated in Delaware), to the exclusion of the law of the state of incorporation, if more than half of the Corporation's shareholders and more than half its "business" (a defined formula based on property, payroll and sales) are located in California. As a result, some companies based in California may be subject to certain provisions of the California corporate law despite being incorporated in another state, such as Delaware (although, as noted below, it is not clear that courts will apply Section 2115 if the law of the jurisdiction of incorporation is inconsistent with the provisions of Section 2115). Section 2115 does not apply to public companies listed on the New York Stock Exchange, the American Stock Exchange, or the NASDAQ National Market.

One provision of the California Corporations Code that applies to such "quasi-California" corporations is Section 708, which requires that shareholders be permitted to cumulate votes in the election of directors. However, Section 2115 does not require corporations to set forth this right in their articles or bylaws, and most Silicon Valley companies that are subject to Section 2115 do not do so. Under Delaware law, a corporation must include a provision in its Certificate of Incorporation in order to allow cumulative voting (see Section 214 of the DGCL). Therefore, should a stockholder choose to exercise its right to cumulate votes under Sections 2115 and 708 of the California Corporations Code, the corporation may find itself forced to choose between violating those provisions if it denies cumulative voting, or violating Section 214 of the DGCL if it allows it. Current California case law enforces a shareholder's rights to cumulate votes in this situation, relying on the language of Section 2115 stating that the cited provisions of the California Code apply "to the exclusion of the law of the jurisdiction in which [the corporation] is incorporated." See *Wilson v. Louisiana-Pacific Resources, Inc.* (138 Cal. App. 3d 216 (1983)). However, a Delaware case, *VantagePoint Venture Partners 1996 v. Examen* (Del. 2005), held that the provisions of Section 2115 of the California Corporation Code, insofar as they purport to regulate what stockholder vote is required to approve a corporate action, are inapplicable to a Delaware corporation, regardless of the Corporation's California contacts. In late May 2012, a California Court of Appeals case, *Lidow v. Superior Court*, 141 Cal. Rptr. 3d 729 (Cal. Ct. App. 2012), for the first time signaled acceptance of the analysis in *VantagePoint* by a California court; however, this decision did not explicitly speak to Section 2115 and practitioners remain advised that it may be prudent for "quasi-California" corporations to comply with Section 2115 whenever possible.

Another provision applicable to such "quasi-California" corporations is the restriction on distributions to shareholders under Section 500 of the California Corporations Code. California Corporations Code Section 166 defines "distributions to shareholders" to include all transfers of cash or property to shareholders without consideration, including dividends paid to shareholders (except stock dividends), and the redemptions or repurchases of stock by a corporation or its subsidiary (subject to certain exclusions, such as the repurchase of stock held by employees). The consequence of this broad definition is that dividends, stock repurchases, and stock redemptions are all subject to the same tests and restrictions. Unlike Delaware law, which generally permits companies to pay dividends or make redemptions as long as the Corporation is solvent following the transaction, California law prohibits such payments unless

*the Corporation meets certain mechanical tests (in particular, that either retained earnings equal or exceed the size of the proposed distribution or that assets equal or exceed current liabilities). Additionally, California requires quasi-California companies to take “preferential dividends” and “preferential rights” into account when making distributions. However, California does allow such companies to waive these preferred stock considerations (see THIRTEENTH in the model charter). As a result of the restrictions in Section 500, quasi-California companies may be precluded by California law from making a required dividend or redemption payment, even though such a payment would be permissible under Delaware law. Under California Corporations Code Section 316(a)(1), also applicable to “quasi-California” corporations, directors are liable to the corporation for illegal distributions if they acted willfully or negligently with respect to such a distribution.*

*The limitations on director and officer indemnification under Section 317 of the California Corporations Code also purport to be applicable to a “quasi-California” corporation. As a result, counsel may want to tailor indemnification provisions for a “quasi-California” corporation to reflect California law so that all parties have consistent expectations with regard to indemnification of officers and directors.*

*Finally, Section 1001 and 1101, and Chapter 12 and 13 of the California Corporations Code also purport to apply to “quasi-California” corporations. These provisions deal with mergers, reorganizations, and asset sales, including voting rights and the application of California dissenters’ rights. California may require class votes on sale transactions, so parties should consider whether additional voting agreements are appropriate to secure a possible Common Stock class vote in such a transaction. Additionally, in contrast to Delaware law, California law will grant dissenters’ rights in connection with the sale of assets in exchange for stock of an acquiring corporation. Furthermore, California law will require a fairness opinion in connection with certain interested party transactions, so the parties should take particular care if a merger, reorganization or asset sale involves a potentially interested party.*

AMENDED AND RESTATED  
CERTIFICATE OF INCORPORATION<sup>2</sup>  
OF  
[\_\_\_\_\_]

(Pursuant to Sections 242 and 245 of the  
General Corporation Law of the State of Delaware)

[\_\_\_\_\_], a corporation organized and existing under and by virtue of the provisions of the General Corporation Law of the State of Delaware (the “**General Corporation Law**”),

**DOES HEREBY CERTIFY:**

**1.** That the name of this corporation is [\_\_\_\_\_], and that this corporation was originally incorporated pursuant to the General Corporation Law on [\_\_\_\_\_, 20\_\_] under the name [\_\_\_\_\_].<sup>3</sup>

**2.** That the Board of Directors duly adopted resolutions proposing to amend and restate the Certificate of Incorporation of this corporation, declaring said amendment and restatement to be advisable and in the best interests of this corporation and its stockholders, and authorizing the appropriate officers of this corporation to solicit the consent of the stockholders therefor, which resolution setting forth the proposed amendment and restatement is as follows:

**RESOLVED**, that the Certificate of Incorporation of this corporation be amended and restated in its entirety to read as follows:

**FIRST:** The name of this corporation is [\_\_\_\_\_] (the “**Corporation**”).

**SECOND:** The address of the registered office of the Corporation in the State of Delaware is [\_\_\_\_\_], in the City of [\_\_\_\_\_], County of [\_\_\_\_\_]. The name of its registered agent at such address is [\_\_\_\_\_].

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<sup>2</sup> Pursuant to Section 242 of the DGCL, a Delaware corporation “may amend its certificate of incorporation, from time to time, in any and as many respects as may be desired, so long as its certificate of incorporation as amended would contain only such provisions as it would be lawful and proper to insert in an original certificate of incorporation filed at the time of the filing of the amendment.” Section 242(b) sets forth the specific requirements that must be followed to properly effect the amendment. Section 245 of the DGCL further permits a Delaware corporation to restate its Certificate of Incorporation in order to “integrate into a single instrument all of the provisions of its certificate of incorporation which are then in effect and operative.” Section 245(c) requires that a restated Certificate of Incorporation shall be specifically designated as such in its heading.

<sup>3</sup> Section 245(c) of the DGCL requires that a restated Certificate of Incorporation state, either in its heading or in an introductory paragraph, the corporation’s present name (and, if it has changed, the name under which it was originally incorporated) and the date the original Certificate of Incorporation was filed with the Secretary of State of Delaware.

**THIRD:** The nature of the business or purposes to be conducted or promoted is to engage in any lawful act or activity for which corporations may be organized under the General Corporation Law.

**FOURTH:** The total number of shares of all classes of stock which the Corporation shall have authority to issue is (i) [\_\_\_\_\_] shares of Common Stock, \$[\_\_\_\_\_] par value per share (“**Common Stock**”), and (ii) [\_\_\_\_\_] shares of Preferred Stock, \$[\_\_\_\_\_] par value per share (“**Preferred Stock**”).<sup>4</sup>

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<sup>4</sup> The number of authorized shares of Common Stock should be high enough to cover all outstanding shares of Common Stock, plus all shares of Common Stock (i) issuable upon exercise of outstanding options and all other uncommitted shares of stock available for grant under the stock plan pool, (ii) issuable upon the conversion of shares of designated Preferred Stock, including, if applicable, accrued dividends, (iii) issuable upon the exercise or conversion of all other securities exercisable for or convertible into Common Stock (e.g., warrants and convertible promissory notes) and (iv) issuable within a reasonable time frame in respect of any compounding dividend, if applicable. Consideration should also be given to authorizing additional shares of Common Stock to permit the Board of Directors to issue such stock in connection with future events, such as acquisitions of other companies or businesses or in lending transactions. Note, however, that many venture capital investors will not permit the authorization of significant amounts of (or even any) additional shares of Common Stock.

The decision to select par or no par stock and, if par, what par value, has two consequences. First, as explained in more detail below, it determines the filing fee owed to the State of Delaware upon filing the Certificate of Incorporation. Second, in Delaware, the aggregate par value of the outstanding stock is subtracted from the net assets of the corporation in determining the amount of the corporation’s funds that are “surplus” lawfully available for the payment of dividends and the repurchase or redemption of stock. See 8 Del. C § § 154 (setting forth how “surplus” is calculated), 170(a) (setting forth the sources of funds from which dividends may lawfully be paid), 160(a) (setting forth the sources of funds from which stock may lawfully be redeemed or repurchased). As is discussed below, both of these consequences counsel in favor of assigning to stock a low par value (but not no par value). The concept of paid in capital being an asset dedicated to protect creditors has passed. Creditors no longer rely solely upon paid in capital or upon the statutory restrictions upon dividends, redemptions, and other distributions to stockholders that “impair” capital to protect their interests. Instead, creditors negotiate and rely upon a wide variety of contractual arrangements to protect their interests, including, for example, loan covenants, security interests and third-party guarantees. See generally Manning and Hanks, *Legal Capital* (3d Ed. 1990).

Corporations incorporated in Delaware are subject to fees for filing their certificates of incorporation and also are required to pay an annual franchise tax. Filing fees for a Certificate of Incorporation are calculated based on the number of authorized shares, and filing fees for an amendment increasing the number of authorized shares are calculated based on the increase in the number of authorized shares. There is no cap on filing fees. For purposes of computing the filing fee on par value stock, each \$100 of authorized capital stock is counted as one taxable share. Accordingly, assigning a low par value to stock can result in a significant reduction in the filing fee. For example, the filing fee on 10,000 \$.01 par value shares is the same as the filing fee on 1 \$100 par value share. No par stock is assumed to be \$100 par for this purpose. Accordingly, in order to minimize the filing fees, a low par value is recommended (\$.01 or less; the State will accept par values as low as \$.00001).

In addition to the filing fees described above, Delaware corporations are required to pay an annual franchise tax which can be no lower than \$35 per annum and no greater than \$165,000 per annum. Within this range, the franchise tax due is the lesser of the amount calculated either on the basis of number of authorized shares (currently \$60 per 10,000 authorized shares) or on the basis of an alternative method which takes into account the corporation’s gross assets and the ratio of its authorized to its issued shares—as a result, the greater the overhang, the greater the franchise tax under the alternative method. Unlike with the filing fee, the par value of the authorized stock does not generally affect the amount of the annual franchise tax owed under the authorized shares method. In addition, the tax is based on authorized shares, not only the number of shares that are issued and outstanding. Accordingly, it is advisable to consider the franchise taxes that will result from a particular capitalization before choosing it.

The following is a statement of the designations and the powers, privileges and rights, and the qualifications, limitations or restrictions thereof in respect of each class of capital stock of the Corporation.

A. COMMON STOCK

1. General. The voting, dividend and liquidation rights of the holders of the Common Stock are subject to and qualified by the rights, powers and preferences of the holders of the Preferred Stock set forth herein.

2. Voting. The holders of the Common Stock are entitled to one vote for each share of Common Stock held at all meetings of stockholders (and written actions in lieu of meetings) [; provided, however, that, except as otherwise required by law, holders of Common Stock, as such, shall not be entitled to vote on any amendment to the Certificate of Incorporation that relates solely to the terms of one or more outstanding series of Preferred Stock if the holders of such affected series are entitled, either separately or together with the holders of one or more other such series, to vote thereon pursuant to the Certificate of Incorporation or pursuant to the General Corporation Law].<sup>5</sup> [There shall be no cumulative voting].<sup>6</sup> [The number of authorized shares of Common Stock may be increased or decreased (but not below the number of shares thereof then outstanding) by (in addition to any vote of the holders of one or more series of Preferred Stock that may be required by the terms of the Certificate of Incorporation) the affirmative vote of the holders of shares of capital stock of the Corporation representing a majority of the votes represented by all outstanding shares of capital stock of the Corporation

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<sup>5</sup> This proviso is intended to ensure that where an amendment to the Certificate of Incorporation (or a Certificate of Designations created pursuant to any “blank check” authority) affects only a series of Preferred Stock, such amendment may be approved by only the holders of the affected series of Preferred Stock, without the necessity of approval by the holders of Common Stock. Section 212 of the General Corporation Law states that, unless otherwise provided in the Certificate of Incorporation, each share of capital stock is entitled to one vote on all matters presented to stockholders for a vote. Any amendment to the Certificate of Incorporation must be effected in accordance with the procedure in Section 242 of the General Corporation Law, which typically includes the vote of the holders of the Common Stock. Accordingly, it may be desirable to provide in the Certificate of Incorporation that only the holders of the affected series of Preferred Stock need vote on an amendment to the terms of such series. This is not a common provision, however, and adding it to the Certificate of Incorporation may require a class vote of the Common Stock.

<sup>6</sup> See the introductory notes to this form regarding Section 2115 of the California Corporations Code. Alternative provision: No person entitled to vote at an election for directors may cumulate votes to which such person is entitled, unless, at the time of such election, the Corporation is subject to Section 2115 of the California Corporations Code. During such time or times that the Corporation is subject to Section 2115(b) of the California Corporations Code, every stockholder entitled to vote at an election for directors may cumulate such stockholder’s votes and give one candidate a number of votes equal to the number of directors to be elected multiplied by the number of votes to which such stockholder’s shares are otherwise entitled, or distribute the stockholder’s votes on the same principle among as many candidates as such stockholder desires. No stockholder, however, shall be entitled to so cumulate such stockholder’s votes unless (i) the names of such candidate or candidates have been placed in nomination prior to the voting and (ii) the stockholder has given notice at the meeting, prior to the voting, of such stockholder’s intention to cumulate such stockholder’s votes. If any stockholder has given proper notice to cumulate votes, all stockholders may cumulate their votes for any candidates who have been properly placed in nomination. Under cumulative voting, the candidates receiving the highest number of votes, up to the number of directors to be elected, are elected.



entitled to vote, irrespective of the provisions of Section 242(b)(2) of the General Corporation Law.]<sup>7</sup>

## B. PREFERRED STOCK

[\_\_\_\_\_] shares of the authorized and unissued Preferred Stock of the Corporation are hereby designated “**Series A Preferred Stock**” with the following rights, preferences, powers, privileges and restrictions, qualifications and limitations. Unless otherwise indicated, references to “sections” or ‘subsections’ in this Part B of this Article Fourth refer to sections and subsections of Part B of this Article Fourth.

### 1. Dividends.<sup>8</sup>

*[Use the following paragraph if the Term Sheet calls for no specific dividend on the Series A Preferred Stock, but an equal sharing if dividends are declared on the Common Stock.]*

The Corporation shall not declare, pay or set aside any dividends on shares of any other class or series of capital stock of the Corporation (other than dividends on shares of Common Stock payable in shares of Common Stock<sup>9</sup>) unless (in addition to the obtaining of any consents required elsewhere in the Certificate of Incorporation) the holders of the Series A Preferred Stock then outstanding shall first receive, or simultaneously receive, a dividend on each outstanding share of Series A Preferred Stock in an amount at least equal to (i) in the case of a dividend on Common Stock or any class or series that is convertible into Common Stock, that dividend per share of Series A Preferred Stock as would equal the product of (A) the dividend payable on each share of such class or series determined, if applicable, as if all shares of such class or series had been converted into Common Stock and (B) the number of shares of Common Stock issuable upon conversion of a share of Series A Preferred Stock, in each case calculated on the record date for determination of holders entitled to receive such dividend or (ii) in the case of a dividend on any class or series that is not convertible into Common Stock, at a rate per share of Series A Preferred Stock determined by (A) dividing the amount of the dividend payable on each share of such class or series of capital stock by the original issuance price of such class or series of capital stock (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to such class or series) and (B) multiplying such fraction by an amount equal to the Series A Original Issue Price (as defined below); provided that, if the Corporation declares, pays or sets aside, on the same date, a

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<sup>7</sup> Note that including the final bracketed sentence requires the approval of the holders of Common Stock unless such provision was contained in the original Certificate of Incorporation. Without such a provision, the holders of the Common Stock effectively retain a class protective vote on subsequent equity financings if the number of authorized shares of Common Stock would need to be increased to accommodate the conversion rights of securities issued in such financings.

<sup>8</sup> Note that this Certificate of Incorporation provides for two bracketed alternative dividend provisions. There are a variety of other alternatives that may be encountered in the market place (including for example, specified non-cumulative dividends), but the drafter should be able to easily adapt one of the two provisions included herein to provide for whatever dividend terms are applicable to a particular transaction.

<sup>9</sup> The reason for this exclusion (and the comparable exclusion in the alternative dividend provisions that follow) is that such dividends are covered by the provisions of Section 4.6 which adjust the Series A Conversion Price in the event of such a dividend.

dividend on shares of more than one class or series of capital stock of the Corporation, the dividend payable to the holders of Series A Preferred Stock pursuant to this Section 1 shall be calculated based upon the dividend on the class or series of capital stock that would result in the highest Series A Preferred Stock dividend. The “**Series A Original Issue Price**” shall mean \$[\_\_\_\_]<sup>10</sup> per share, subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to the Series A Preferred Stock.

*[Use the following paragraph if the Term Sheet calls for a specified cumulative dividend, payable if and when declared by the Board.]*

From and after the date of the issuance of any shares of Series A Preferred Stock, dividends at the rate per annum of \$[\_\_\_\_] per share<sup>11</sup> shall accrue on such shares of Series A Preferred Stock (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to the Series A Preferred Stock) (the “**Accruing Dividends**”). Accruing Dividends shall accrue from day to day, whether or not declared, and shall be cumulative; provided however, that except as set forth in the following sentence of this Section 1 [or in Subsection 2.1 and Section 6]<sup>12</sup>, such Accruing Dividends shall be payable only when, as, and if declared by the Board of Directors and the Corporation shall be under no obligation to pay such Accruing Dividends. The Corporation shall not declare, pay or set aside any dividends on shares of any other class or series of capital stock of the Corporation (other than dividends on shares of Common Stock payable in shares of Common Stock) unless (in addition to the obtaining of any consents required elsewhere in the Certificate of Incorporation) the holders of the Series A Preferred Stock then outstanding shall first receive, or simultaneously receive, a dividend on each outstanding share of Series A Preferred Stock in an amount at least equal to [the greater of][the sum of]<sup>13</sup> (i) the amount of the aggregate Accruing Dividends then accrued on such share of Series A Preferred Stock and not previously paid and (ii) (A) in the case of a dividend on Common Stock or any class or series that is convertible into Common Stock, that dividend per share of Series A Preferred Stock as would equal the product of (1) the dividend payable on each share of such class or series determined, if applicable, as if all shares of such class or series had been converted into Common Stock and (2) the number of shares of Common Stock issuable upon conversion of a share of Series A Preferred Stock, in each case calculated on the record date for determination of holders entitled to receive such dividend or (B) in the case of a dividend on any class or series that is not convertible into Common Stock, at a rate per share of Series A Preferred Stock determined by (1) dividing the amount of the dividend payable on each share of such class or series of capital stock by the original issuance price of such class or series of capital stock (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to such class or series) and (2) multiplying such fraction by an amount equal to the Series A Original Issue Price (as defined below); provided that, if the Corporation declares, pays or sets aside, on the same date, a dividend on shares of more than one class or series of capital stock of the Corporation, the dividend payable to the holders of Series A Preferred Stock pursuant to this Section 1 shall be calculated based upon the dividend on the class or series of capital stock that would result in the highest Series A Preferred Stock dividend. The “**Series A Original Issue Price**” shall mean \$[\_\_\_\_]<sup>14</sup> per share, subject to appropriate adjustment in the event of any stock

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<sup>10</sup> Insert initial Series A purchase price.

dividend, stock split, combination or other similar recapitalization with respect to the Series A Preferred Stock.

2. Liquidation, Dissolution or Winding Up; Certain Mergers, Consolidations and Asset Sales.

*[Use the following Subsections 2.1 and 2.2 if the term sheet calls for non-participating Preferred Stock.]*

2.1 Preferential Payments to Holders of Series A Preferred Stock. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation or Deemed Liquidation Event, the holders of shares of Series A Preferred Stock then outstanding shall be entitled to be paid out of the assets of the Corporation available for distribution to its stockholders before any payment shall be made to the holders of Common Stock by reason of their ownership thereof, an amount per share equal to the greater of (i) [\_\_ times] the Series A Original Issue Price, plus any dividends declared but unpaid thereon,<sup>15</sup> or (ii) such amount per share as would have been payable had all shares of Series A Preferred Stock been converted into Common Stock pursuant to Section 4 immediately prior to such liquidation, dissolution, winding up or Deemed Liquidation Event (the amount payable pursuant to this sentence is hereinafter referred to as the “**Series A Liquidation Amount**”).<sup>16</sup> If upon any such

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<sup>11</sup> A cumulative dividend expressed as “\$\_\_\_ per share” will by definition be non-compounding. If a compounding accrued dividend is desired, it should be expressed as a percentage of a “base amount”, with the “base amount” defined as the original purchase price plus the amount of previously accrued dividends (it should also be specified whether this “compounding” of the original purchase price is done on an annual, quarterly, etc. basis).

<sup>12</sup> Insert the bracketed language if the holders of Series A Preferred Stock will receive the benefit of the accruing dividends upon a liquidation event or upon redemption.

<sup>13</sup> Note that the second bracketed alternative may not be sensible with respect to dividends paid on another series of Preferred Stock, particularly one which contains a reciprocal dividend provision, as it may result in an endless series of payments as any payment with respect to one series would trigger a payment with respect to the other). This provision (and the similar provision in the first alternative dividend paragraph) are likely to be of little practicable import, as most venture capital-backed companies do not have the cash flow to make any dividend payments, and the negative covenants (contained in Subsection 3.3) prohibit dividend payments without the consent of some percentage of the holders of Series A Preferred Stock.

<sup>14</sup> Insert initial Series A purchase price.

<sup>15</sup> If accruing dividends are provided for, the following language would generally be used instead: “the Series A Original Issue Price, plus any Accruing Dividends accrued but unpaid thereon, whether or not declared, together with any other dividends declared but unpaid thereon”.

<sup>16</sup> If this form is being modified to add Series B Preferred Stock as part of these Preferred Stock terms, the calculation of the Series A Liquidation Amount and the Series B Liquidation Amount becomes quite complicated, for the following reason. In determining whether the payment to the holders of any particular series of Preferred Stock would be maximized by the conversion of those shares into Common Stock, it is necessary to make an assumption as to which shares of Preferred Stock have converted into Common Stock. The most logical approach is to assume the conversion into Common Stock of all shares of each series of Preferred Stock that would receive a greater per share liquidation payment if converted into Common Stock than if remaining as Preferred Stock, and to provide (in the version of the Certificate of Incorporation incorporating the Series B Preferred Stock terms) that this assumption shall apply in making the calculation required by this sentence. However, determining the amount provided for in clause (ii) of this sentence for any particular series of Preferred Stock requires you to calculate the Liquidation Amount for each other series of Preferred Stock (so you can calculate the amount available for distribution to the holders of Common Stock and the series of Preferred Stock in question); and calculating the (Footnote continued on next page)

liquidation, dissolution or winding up of the Corporation or Deemed Liquidation Event, the assets of the Corporation available for distribution to its stockholders shall be insufficient to pay the holders of shares of Series A Preferred Stock the full amount to which they shall be entitled under this Subsection 2.1, the holders of shares of Series A Preferred Stock shall share ratably in any distribution of the assets available for distribution in proportion to the respective amounts which would otherwise be payable in respect of the shares held by them upon such distribution if all amounts payable on or with respect to such shares were paid in full.

2.2 Payments to Holders of Common Stock. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation or Deemed Liquidation Event, after the payment of all preferential amounts required to be paid to the holders of shares of Series A Preferred Stock, the remaining assets of the Corporation available for distribution to its stockholders shall be distributed among the holders of shares of Common Stock, pro rata based on the number of shares held by each such holder.

*[Use the following Subsections 2.1 and 2.2 if the term sheet calls for participating Preferred Stock.]*

2.3 Preferential Payments to Holders of Series A Preferred Stock. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation or Deemed Liquidation Event, the holders of shares of Series A Preferred Stock then outstanding shall be entitled to be paid out of the assets of the Corporation available for distribution to its stockholders before any payment shall be made to the holders of Common Stock by reason of their ownership thereof, an amount per share equal to [\_\_\_ times] the Series A Original Issue Price, plus any dividends declared but unpaid thereon.<sup>17</sup> If upon any such

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Liquidation Amount for each such other series itself involves a determination of whether the original purchase price for such other series of Preferred Stock (plus dividends, if applicable) exceeds the amount payable with respect to such series on an as-converted basis – and this latter amount cannot be calculated without knowing what the Liquidation Amounts are for all other series of Preferred Stock. If the various series of Preferred Stock are not *pari passu*, these calculations become even more difficult.

Some versions of Preferred Stock terms simply state that the liquidation payment to be made to a particular series of Preferred Stock is equal to the original purchase price of such Preferred Stock (plus dividends, if applicable) rather than the higher of such amount and the as-converted payment. That alternative formulation is not intended to result in a substantive difference from the approach taken in this form; rather, in that alternative formulation, it is assumed that the holders of a particular series of Preferred Stock would simply convert into Common Stock if the as-converted payment is greater than the original purchase price (plus dividends, if applicable). While such alternative formulation avoids the drafting complexities described in the preceding paragraph, it simply shifts those complexities to the decision each individual holder of Preferred Stock must make at the time of a liquidation event. That is, each holder of Preferred Stock must decide whether it will receive a higher payment if it converts into Common Stock; and such determination would require each holder of Preferred Stock to make an assumption as to whether the other holders of Preferred Stock (both of the same series and of different series) will convert into Common Stock.

This issue is not applicable to participating Preferred Stock without a cap on the liquidation preference – because participating Preferred Stock entitles its holder to receive both the basic liquidation payment and the as-converted payment, there is no need to determine whether the basic payment or the as-converted payment is greater.

<sup>17</sup> If accruing dividends are provided for, the following language would generally be used instead: “the Series A Original Issue Price, plus any Accruing Dividends accrued but unpaid thereon, whether or not declared, together with any other dividends declared but unpaid thereon.”

liquidation, dissolution or winding up of the Corporation or Deemed Liquidation Event, the assets of the Corporation available for distribution to its stockholders shall be insufficient to pay the holders of shares of Series A Preferred Stock the full amount to which they shall be entitled under this Subsection 2.1, the holders of shares of Series A Preferred Stock shall share ratably in any distribution of the assets available for distribution in proportion to the respective amounts which would otherwise be payable in respect of the shares held by them upon such distribution if all amounts payable on or with respect to such shares were paid in full.

2.4 Distribution of Remaining Assets. In the event of any voluntary or involuntary liquidation, dissolution or winding up of the Corporation or Deemed Liquidation Event, after the payment of all preferential amounts required to be paid to the holders of shares of Series A Preferred Stock the remaining assets of the Corporation available for distribution to its stockholders shall be distributed among the holders of the shares of Series A Preferred Stock and Common Stock, pro rata based on the number of shares held by each such holder, treating for this purpose all such securities as if they had been converted to Common Stock pursuant to the terms of the Certificate of Incorporation immediately prior to such dissolution, liquidation or winding up of the Corporation.<sup>18</sup> The aggregate amount which a holder of a share of Series A Preferred Stock is entitled to receive under Subsections 2.1 and 2.2 is hereinafter referred to as the “**Series A Liquidation Amount.**”

2.5 Deemed Liquidation Events.<sup>19</sup>

2.5.1 Definition. Each of the following events shall be considered a “**Deemed Liquidation Event**” unless the holders of at least [*specify percentage*]<sup>20</sup> of the outstanding shares of Series A Preferred Stock elect otherwise by written notice sent to the Corporation at least [ ] days prior to the effective date of any such event:

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<sup>18</sup> If a cap to the liquidation preference is specified in the term sheet, add the following language at the end of this sentence: “; provided, however, that if the aggregate amount which the holders of Series A Preferred Stock are entitled to receive under Subsections 2.1 and 2.2 shall exceed [\$ ] per share (subject to appropriate adjustment in the event of a stock split, stock dividend, combination, reclassification, or similar event affecting the Series A Preferred Stock) (the “Maximum Participation Amount”), each holder of Series A Preferred Stock shall be entitled to receive upon such liquidation, dissolution or winding up of the Corporation the greater of (i) the Maximum Participation Amount and (ii) the amount such holder would have received if all shares of Series A Preferred Stock had been converted into Common Stock immediately prior to such liquidation, dissolution or winding up of the Corporation.”

<sup>19</sup> It is generally unadvisable to insert language that includes a change of control transaction as a Deemed Liquidation Event, as such transactions may not be within the control of the Corporation and, in any event, could be inadvertently triggered with unintended consequences. A better practice is to protect against such events through a combination of other measures, including protective provisions regarding the issuance of stock and rights of first refusal over transfers of stock by other stockholders. Counsel should be aware, however, that protective provisions and rights of first refusal may not be sufficient to protect against all eventualities, particularly given that many venture capital investors refuse to subject their own shares to transfer restrictions such as a right of first refusal.

<sup>20</sup> The vote required to waive the treatment of a particular transaction as a Deemed Liquidation Event is generally the same vote that would be required to amend this provision under the terms of Subsection 3.3.

- (a) a merger or consolidation<sup>21</sup> in which
  - (i) the Corporation is a constituent party or
  - (ii) a subsidiary of the Corporation is a constituent party and the Corporation issues shares of its capital stock pursuant to such merger or consolidation,

except any such merger or consolidation involving the Corporation or a subsidiary in which the shares of capital stock of the Corporation outstanding immediately prior to such merger or consolidation continue to represent, or are converted into or exchanged for shares of capital stock that represent, immediately following such merger or consolidation, at least a [majority], by voting power, of the capital stock of (1) the surviving or resulting corporation or (2) if the surviving or resulting corporation is a wholly owned subsidiary of another corporation immediately following such merger or consolidation, the parent corporation of such surviving or resulting corporation; or

(b) the sale, lease, transfer, exclusive license or other disposition, in a single transaction or series of related transactions, by the Corporation or any subsidiary of the Corporation of all or substantially all the assets of the Corporation and its subsidiaries taken as a whole (including, without limitation, [\_\_\_\_\_]),<sup>22</sup> or the sale or disposition (whether by merger or otherwise) of one or more subsidiaries of the Corporation if substantially all of the assets of the Corporation and its subsidiaries taken as a whole are held by such subsidiary or subsidiaries, except where such sale, lease, transfer, exclusive license or other disposition is to a wholly owned subsidiary of the Corporation.

#### 2.5.2 Effecting a Deemed Liquidation Event.

(a) The Corporation shall not have the power to effect a Deemed Liquidation Event referred to in Subsection 2.3.1(a)(i) unless the agreement or plan of merger or consolidation for such transaction (the “**Merger Agreement**”) provides that the consideration payable to the stockholders of the Corporation shall be allocated among the holders of capital stock of the Corporation in accordance with Subsections 2.1 and 2.2.

(b) In the event of a Deemed Liquidation Event referred to in Subsection 2.3.1(a)(ii) or 2.3.1(b), if the Corporation does not effect a dissolution of the Corporation under the General Corporation Law within 90 days after such Deemed Liquidation Event, then (i) the Corporation shall send a written notice to each holder of Series A Preferred Stock no later than the 90th day after the Deemed Liquidation Event advising such holders of their right (and the requirements to be met to secure such right) pursuant to the terms of the following clause (ii) to require the redemption of such shares of Series A Preferred Stock, and (ii) if the holders of at least [*specify percentage*] of the then outstanding shares of Series A

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<sup>21</sup> If the Corporation is incorporated in a state whose corporate statute provides for statutory share exchanges (Delaware currently does not), a share exchange transaction should be referenced (along with a merger or consolidation) in Subsection 2.3.1(a), as well as in 2.3.2(a) below.

<sup>22</sup> Occasionally, it may be appropriate to specify important assets of the Corporation.

Preferred Stock so request in a written instrument delivered to the Corporation not later than 120 days after such Deemed Liquidation Event, the Corporation shall use the consideration received by the Corporation for such Deemed Liquidation Event (net of any retained liabilities associated with the assets sold or technology licensed, as determined in good faith by the Board of Directors of the Corporation), together with any other assets of the Corporation available for distribution to its stockholders, all to the extent permitted by Delaware law governing distributions to stockholders (the “**Available Proceeds**”), on the 150th day after such Deemed Liquidation Event, to redeem all outstanding shares of Series A Preferred Stock at a price per share equal to the Series A Liquidation Amount. Notwithstanding the foregoing, in the event of a redemption pursuant to the preceding sentence, if the Available Proceeds are not sufficient to redeem all outstanding shares of Series A Preferred Stock, the Corporation shall ratably redeem each holder’s shares of Series A Preferred Stock to the fullest extent of such Available Proceeds, and shall redeem the remaining shares as soon as it may lawfully do so under Delaware law governing distributions to stockholders. The provisions of Section 6 shall apply, with such necessary changes in the details thereof as are necessitated by the context, to the redemption of the Series A Preferred Stock pursuant to this Subsection 2.3.2(b).<sup>23</sup> Prior to the distribution or redemption provided for in this Subsection 2.3.2(b), the Corporation shall not expend or dissipate the consideration received for such Deemed Liquidation Event, except to discharge expenses incurred in connection with such Deemed Liquidation Event [or in the ordinary course of business].

2.5.3 Amount Deemed Paid or Distributed.<sup>24</sup> The amount deemed paid or distributed to the holders of capital stock of the Corporation upon any such merger, consolidation, sale, transfer, exclusive license, other disposition or redemption shall be the cash or the value of the property, rights or securities paid or distributed to such holders by the

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<sup>23</sup> In the event the Series A Preferred Stock is not redeemable, replace this sentence with modified versions of Subsection 6.2 through 6.4.

<sup>24</sup> Alternative provision: Amount of Deemed Paid or Distributed. If the amount deemed paid or distributed under this Subsection 2.3.3 is made in property other than in cash, the value of such distribution shall be the fair market value of such property, determined as follows:

(a) For securities not subject to investment letters or other similar restrictions on free marketability,

(i) if traded on a securities exchange, the value shall be deemed to be the average of the closing prices of the securities on such exchange or market over the 30-period ending three days prior to the closing of such transaction;

(ii) if actively traded over-the-counter, the value shall be deemed to be the average of the closing bid prices over the 30-day period ending three days prior to the closing of such transaction; or

(iii) if there is no active public market, the value shall be the fair market value thereof, as determined in good faith by the Board of Directors of the Corporation.

(b) The method of valuation of securities subject to investment letters or other similar restrictions on free marketability (other than restrictions arising solely by virtue of a stockholder’s status as an affiliate or former affiliate) shall take into account an appropriate discount (as determined in good faith by the Board of Directors of the Corporation) from the market value as determined pursuant to clause (a) above so as to reflect the approximate fair market value thereof.

Corporation or the acquiring person, firm or other entity. [The value of such property, rights or securities shall be determined in good faith by the Board of Directors of the Corporation.]<sup>25</sup>

**2.5.4 Allocation of Escrow and Contingent Consideration.** In the event of a Deemed Liquidation Event pursuant to Subsection 2.3.1(a)(i), if any portion of the consideration payable to the stockholders of the Corporation is payable only upon satisfaction of contingencies (the “**Additional Consideration**”), the Merger Agreement shall provide that (a) the portion of such consideration that is not Additional Consideration (such portion, the “**Initial Consideration**”) shall be allocated among the holders of capital stock of the Corporation in accordance with Subsections 2.1 and 2.2 as if the Initial Consideration were the only consideration payable in connection with such Deemed Liquidation Event and (b) any Additional Consideration which becomes payable to the stockholders of the Corporation upon satisfaction of such contingencies shall be allocated among the holders of capital stock of the Corporation in accordance with Subsections 2.1 and 2.2 after taking into account the previous payment of the Initial Consideration as part of the same transaction. For the purposes of this Subsection 2.3.4, consideration placed into escrow or retained as holdback to be available for satisfaction of indemnification or similar obligations in connection with such Deemed Liquidation Event shall be deemed to be [Initial Consideration] [Additional Consideration].<sup>26</sup>

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<sup>25</sup> Investor counsel may seek to add further investor protection by providing that, if a specified percentage of the Series A holders object to the valuation, then the value shall be the FMV as mutually determined by the Corporation and the specified Series A holders, and if the Corporation and those Series A holders are unable to reach agreement, then FMV shall be established by an independent appraisal. If such a provision is used, the procedural details (e.g., how appraiser is to be selected, who pays, is the appraisal binding, etc.) should be spelled out.

<sup>26</sup> This section addresses two related issues that may arise when a venture-capital backed company is acquired in a merger: (1) the allocation of earn-out or performance-based consideration, if any and (2) how any deductions from the merger consideration to fund an indemnity escrow or holdback are allocated among the holders of capital stock of the company. This provision is designed to address both issues, with optional language regarding the treatment of escrow.

In transactions involving earn-out or performance-based consideration, one approach is to allocate the closing proceeds in accordance with the liquidation provisions of the Certificate of Incorporation as if such closing proceeds were the only amounts payable in the transaction. If, subsequent to the closing of the transaction, any additional payments are made upon satisfaction of earn-out or performance-based contingencies, the liquidation provisions would be re-applied to ensure that the aggregate consideration is allocated as it would have been were the closing and post-closing payments made at a single time. Alternatively, in a transaction where the closing proceeds were less than the aggregate liquidation preference of the Preferred Stock and potential earn-out payments were of sufficient size as to result in full conversion of all Preferred Stock (assuming such Preferred Stock was not fully participating) and all proceeds shared pro rata on an as-converted basis, it has occasionally been argued that in the absence of explicit language to the contrary, the holders of Preferred Stock must choose to either be paid their liquidation preference from the closing proceeds and forego any as-converted based participation in the earn-out, or convert into Common Stock prior to the closing and thereby waive any liquidation preference in order to preserve the ability to participate in the distribution of earn-out proceeds on an as-converted basis. Given the consensus view that such alternative is inconsistent with the bargain implicit in a preferred security, this Subsection 2.3.4 makes it clear that the “greater of preference or participation” character of Preferred Stock survives in transaction involving contingent consideration.

With respect to the allocation of amounts placed in escrow or subject to holdback to be available for the satisfaction of indemnity obligations, Subsection 2.3.4 contains optional language that permits such amounts to either be treated as “Initial Consideration” and paid with the closing proceeds and withheld on a pro rata basis from (Footnote continued on next page)



### 3. Voting.

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all stockholders, or instead treated as “Additional Consideration” (e.g. a separate contingent payment), which results in the holders of Preferred Stock always receiving their liquidation preference, even if some or all of the escrow is forfeited (see further discussion on this point below). If escrowed amounts are to be treated as “Initial Consideration”, the parties may wish to consider whether future earn-out payments in such transaction should take into account whether any portion of such escrow amounts have been paid to the buyer or other third parties prior to the time such earn-out payments are made – e.g., whether the earn-out should “backfill” any escrow dollars applied as liquidation preference but not eventually paid.

From the perspective of the holders of Preferred Stock, the pro rata approach resulting from treating the escrowed amount as “Initial Consideration” may not give them the full benefit of their bargained-for liquidation preference because if not all of the escrow is ultimately released to company stockholders, it can result in the Preferred Stock holders receiving less, and the Common Stock holders receiving more, than they would have been entitled to receive if the reduced consideration had been allocated in the manner provided for in the Certificate of Incorporation. The difference between the two approaches is illustrated by the following example:

- 100 shares of Series A Preferred Stock and 100 shares of Common Stock are outstanding;
- the Series A Preferred Stock has a liquidation preference of \$1.00 per share, and is non-participating;
- the purchase price for the company is \$150; and
- \$15 is placed in escrow, which ultimately is returned to the acquirer (such the actual purchase price turns out to be \$135).

If the escrow were allocated among all stockholders pro rata, the initial \$135 payment would be allocated \$90 to the holders of Series A Preferred Stock and \$45 to the holders of Common Stock; and the escrow would be allocated \$10 to the holders of Series A Preferred Stock and \$5 to the holders of Common Stock. If the escrow were later paid to the stockholders, the \$150 purchase price would be allocated as the Certificate of Incorporation provides – \$100 to the Series A holders and \$50 to the Common holders. On the other hand, if the \$15 escrow were forfeited, the \$135 purchase price would be allocated \$90 to the Series A holders and \$45 to the Common holders. However, according to the liquidation provisions of the Certificate of Incorporation, a purchase price of \$135 should be allocated \$100 to the holders of Series A Preferred Stock and \$35 to the holders of Common Stock. Thus this pro rata allocation of the escrow could provide a smaller payout to the Preferred Stock holders than would be the result if the liquidation provisions of the Certificate of Incorporation were applied to the reduced purchase price (after deducting the forfeited escrow proceeds).

Deeming the escrowed consideration as “Additional Consideration” ensures that the Preferred Stock holders always receive their liquidation preference, even if some or all of the escrow is forfeited –the initial payment of \$135 would be allocated \$100 to the Series A holders and \$35 to the Common holders, and all \$15 of the escrow would be allocated to the Common holders (with any proceeds released from escrow also going solely to the Common holders). Whether the escrow is forfeited or paid to the holders of Common Stock, the result would be an allocation that is consistent with how the Certificate of Incorporation would allocate whatever the ultimate purchase price turns out to be.

If the Certificate of Incorporation is silent on allocation of escrow and contingent consideration, at the time of an acquisition the company’s Board of Directors will have to approve allocations without the benefit of a Certificate of Incorporation provision stipulating how that should be done. This could create the risk that some constituency will have grounds to complain about the Board’s decision, including a claim that the terms of the merger agreement are inconsistent with the liquidation provisions of the Certificate of Incorporation addressing how merger consideration must be allocated among the various series and classes of stock of the company.

3.1 General. On any matter presented to the stockholders of the Corporation for their action or consideration at any meeting of stockholders of the Corporation (or by written consent of stockholders in lieu of meeting), each holder of outstanding shares of Series A Preferred Stock shall be entitled to cast the number of votes equal to the number of whole shares of Common Stock into which the shares of Series A Preferred Stock held by such holder are convertible as of the record date for determining stockholders entitled to vote on such matter. Except as provided by law or by the other provisions of the Certificate of Incorporation, holders of Series A Preferred Stock shall vote together with the holders of Common Stock as a single class.

3.2 Election of Directors. The holders of record of the shares of Series A Preferred Stock, exclusively and as a separate class, shall be entitled to elect [ ] directors of the Corporation (the “**Series A Directors**”) and the holders of record of the shares of Common Stock, exclusively and as a separate class, shall be entitled to elect [ ] directors of the Corporation.<sup>27</sup> Any director elected as provided in the preceding sentence may be removed without cause by, and only by, the affirmative vote of the holders of the shares of the class or series of capital stock entitled to elect such director or directors, given either at a special meeting of such stockholders duly called for that purpose or pursuant to a written consent of stockholders. If the holders of shares of Series A Preferred Stock or Common Stock, as the case may be, fail to elect a sufficient number of directors to fill all directorships for which they are entitled to elect directors, voting exclusively and as a separate class, pursuant to the first sentence of this Subsection 3.2, then any directorship not so filled shall remain vacant until such time as the holders of the Series A Preferred Stock or Common Stock, as the case may be, elect a person to fill such directorship by vote or written consent in lieu of a meeting; and no such directorship may be filled by stockholders of the Corporation other than by the stockholders of the Corporation that are entitled to elect a person to fill such directorship, voting exclusively and as a separate class.<sup>28</sup> The holders of record of the shares of Common Stock and of any other class or series of voting stock (including the Series A Preferred Stock), exclusively and voting together as a single class, shall be entitled to elect the balance of the total number of directors of the Corporation. At any meeting held for the purpose of electing a director, the presence in person or by proxy of the holders of a majority of the outstanding shares of the class or series entitled to elect such director shall constitute a quorum for the purpose of electing such director. Except as otherwise provided in this Subsection 3.2, a vacancy in any directorship filled by the holders of any class or series shall be filled only by vote or written consent in lieu of a meeting of the holders of such class or series or by any remaining director or directors elected by the holders of such class or series pursuant to this Subsection 3.2. [The rights of the holders of the Series A Preferred Stock and the rights of the holders of the Common Stock under the first sentence of this Subsection 3.2 shall terminate on the first date following the Series A Original Issue Date (as defined below) on which there are issued and outstanding less than [ ] shares of Series A Preferred Stock (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to the Series A Preferred Stock).]

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<sup>27</sup> The size of the Board of Directors is typically fixed in the By-laws (which permits it to be amended without the need for a charter amendment), though it could be fixed here. The Voting Agreement also typically obligates the parties to vote to fix the size of the Board at a specified number of directors.

<sup>28</sup> This sentence has been added in response to *FGC Holdings Ltd. v. Teltronics, Inc.*, Case No. C.A. 883-N (Del. Ch. Ct. 9/14/05).

3.3 Series A Preferred Stock Protective Provisions. At any time when [shares of Series A Preferred Stock] [at least [\_\_\_\_\_] shares of Series A Preferred Stock (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to the Series A Preferred Stock)] are outstanding, the Corporation shall not, either directly or indirectly by amendment, merger, consolidation or otherwise, do any of the following without (in addition to any other vote required by law or the Certificate of Incorporation) the written consent or affirmative vote of the holders of at least [*specify percentage*] of the then outstanding shares of Series A Preferred Stock, given in writing or by vote at a meeting, consenting or voting (as the case may be) separately as a class,<sup>29</sup> and any such act or transaction entered into without such consent or vote shall be null and void *ab initio*, and of no force or effect.<sup>30</sup>

3.3.1 liquidate, dissolve or wind-up the business and affairs of the Corporation, effect any merger or consolidation<sup>31</sup> or any other Deemed Liquidation Event,<sup>32</sup> or consent to any of the foregoing;

3.3.2 amend, alter or repeal any provision of the Certificate of Incorporation or Bylaws of the Corporation [in a manner that adversely affects the powers, preferences or rights of the Series A Preferred Stock];<sup>33</sup>

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<sup>29</sup> Consider including here some or all of the additional restrictions in section 5.5 of the Model Investors' Rights Agreement (which, as set forth in that form, require the consent of some number of the investor-designated directors). Bear in mind that if the matter may be waived by a vote of a specified portion of the Board, any investor-designated director will be constrained by his or her fiduciary duties to the Corporation. Also, if the consent rights are contained in the charter, the investor can argue that an act by the Corporation in contravention of those provisions would be void or voidable rather than simply a breach of contract. *But see* footnote 30.

<sup>30</sup> This language has been added in response to the Delaware Chancery Court's opinion in *Fletcher Int'l, Ltd. v. ION Geophysical Corp., Case No. C.A. 5109-VCP (Del. Ch. Ct. 5/28/10)*, where the court declined to unwind promissory notes issued by the defendant corporation in apparent violation of a preferred stock consent right in its charter. Rather than simply declaring the issuance void and ordering the transaction to be rescinded, the court applied an injunction standard and concluded that, although the preferred stockholder had proven the likelihood that its consent right had been contravened, compensatory damages were calculable (or another equitable remedy might be available), and, in balancing the potential harms to the parties, held that the corporation would suffer the greater harm were it forced to return the borrowed funds.

<sup>31</sup> The purpose of including the broader language relating to "any merger or consolidation" is to prevent mergers that have no independent economic substance but rather are effected for the sole purpose of subverting the terms of the outstanding Series A Preferred Stock (see, e.g., *Benchmark Capital Partners IV, L.P. v. Vague, Case No. C.A. 19719 (Del. Ch. Ct. 7/15/02)*). If the investors have not negotiated for a veto right on a sale of the company, the provision might instead read "effect any merger or consolidation, other than a Deemed Liquidation Event." If the parties consider such provision too broad, the investors are nevertheless well advised to include an additional protective provision prohibiting any mergers or consolidations that result in conversion of the preferred stock other than in accordance with the provisions of Sections 4 and 5, in order to prevent any mischief.

<sup>32</sup> A Deemed Liquidation Event is defined to include a sale or disposition, by the Corporation or any subsidiary, of substantially all of the assets of the Corporation and its subsidiaries taken as a whole. See clause (g) for a prohibition on dispositions of assets by subsidiaries that do not rise to the level of a Deemed Liquidation Event.

<sup>33</sup> Under Delaware law, the authorization of another series of Preferred Stock with rights senior to those of the Series A Preferred Stock as to dividends, liquidation and redemption would generally not constitute an amendment that adversely affects the Series A Preferred Stock. Accordingly, the following subsection contains additional restrictions specifically dealing with the authorization of senior or *pari passu* stock.

3.3.3 create, or authorize the creation of, [or issue or obligate itself to issue shares of,] any additional class or series of capital stock [unless the same ranks junior to the Series A Preferred Stock with respect to the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends and rights of redemption], or increase the authorized number of shares of Series A Preferred Stock or increase the authorized number of shares of any additional class or series of capital stock [unless the same ranks junior to the Series A Preferred Stock with respect to the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends and rights of redemption];

3.3.4 (i) reclassify, alter or amend any existing security of the Corporation that is *pari passu* with the Series A Preferred Stock in respect of the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends or rights of redemption, if such reclassification, alteration or amendment would render such other security senior to the Series A Preferred Stock in respect of any such right, preference or privilege, or (ii) reclassify, alter or amend any existing security of the Corporation that is junior to the Series A Preferred Stock in respect of the distribution of assets on the liquidation, dissolution or winding up of the Corporation, the payment of dividends or rights of redemption, if such reclassification, alteration or amendment would render such other security senior to or *pari passu* with the Series A Preferred Stock in respect of any such right, preference or privilege;

3.3.5 purchase or redeem (or permit any subsidiary to purchase or redeem) or pay or declare any dividend or make any distribution on, any shares of capital stock of the Corporation other than (i) redemptions of or dividends or distributions on the Series A Preferred Stock as expressly authorized herein, (ii) dividends or other distributions payable on the Common Stock solely in the form of additional shares of Common Stock and (iii) repurchases of stock from former employees, officers, directors, consultants or other persons who performed services for the Corporation or any subsidiary in connection with the cessation of such employment or service at the lower of the original purchase price or the then-current fair market value thereof [or (iv) as approved by the Board of Directors, including the approval of at least one Series A Director];<sup>34</sup>

3.3.6 create, or authorize the creation of, or issue, or authorize the issuance of any debt security, or permit any subsidiary to take any such action with respect to any debt security [, if the aggregate indebtedness of the Corporation and its subsidiaries for borrowed money following such action would exceed \$\_\_\_\_\_] [other than equipment leases or bank lines of credit] [unless such debt security has received the prior approval of the Board of Directors, including the approval of [at least one] Series A Director]<sup>35</sup>; [or]

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<sup>34</sup> Inclusion of a requirement that Board approval include approval by a Series A Director is frequently seen as a compromise between requiring approval of the holders of Series A Preferred Stock (*qua*-stockholders) and simply requiring Board approval. However, prior to inclusion of the bracketed language, consideration should be given to the fact that any board-level approval of the Series A Director (as opposed to stockholder approval by the holders of Series A Preferred Stock) will be in such director's capacity as a member of the board of directors and therefore subject to such director's fiduciary duties to the corporation.

<sup>35</sup> See footnote 34.

3.3.7 create, or hold capital stock in, any subsidiary that is not wholly owned (either directly or through one or more other subsidiaries) by the Corporation, or sell, transfer or otherwise dispose of any capital stock of any direct or indirect subsidiary of the Corporation, or permit any direct or indirect subsidiary to sell, lease, transfer, exclusively license or otherwise dispose (in a single transaction or series of related transactions) of all or substantially all of the assets of such subsidiary[.]; or]

3.3.8 [increase or decrease the authorized number of directors constituting the Board of Directors].<sup>36</sup>

#### 4. Optional Conversion.

The holders of the Series A Preferred Stock shall have conversion rights as follows (the “**Conversion Rights**”):

##### 4.1 Right to Convert.

4.1.1 Conversion Ratio. Each share of Series A Preferred Stock shall be convertible, at the option of the holder thereof, at any time and from time to time, and without the payment of additional consideration by the holder thereof, into such number of fully paid and nonassessable shares of Common Stock as is determined by dividing the Series A Original Issue Price by the Series A Conversion Price (as defined below) in effect at the time of conversion. The “**Series A Conversion Price**” shall initially be equal to \$\_\_\_\_\_ [*insert original purchase price of Series A Preferred Stock*].<sup>37</sup> Such initial Series A Conversion Price, and the rate at which shares of Series A Preferred Stock may be converted into shares of Common Stock, shall be subject to adjustment as provided below.

4.1.2 Termination of Conversion Rights. In the event of a notice of redemption of any shares of Series A Preferred Stock pursuant to Section 6, the Conversion Rights of the shares designated for redemption shall terminate at the close of business on the last full day preceding the date fixed for redemption, unless the redemption price is not fully paid on such redemption date, in which case the Conversion Rights for such shares shall continue until such price is paid in full.<sup>38</sup> In the event of a liquidation, dissolution or winding up of the Corporation or a Deemed Liquidation Event, the Conversion Rights shall terminate at the close of business on the last full day preceding the date fixed for the payment of any such amounts distributable on such event to the holders of Series A Preferred Stock.

4.2 Fractional Shares. No fractional shares of Common Stock shall be issued upon conversion of the Series A Preferred Stock. In lieu of any fractional shares to which the holder would otherwise be entitled, the Corporation shall pay cash equal to such fraction multiplied by the fair market value of a share of Common Stock as determined in good faith by the Board of Directors of the Corporation. Whether or not fractional shares would be issuable

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<sup>36</sup> This provision often is addressed in the Voting Agreement rather than in the Certificate of Incorporation.

<sup>37</sup> Remember in future rounds to substitute a different number, if there have been adjustments to the Series A Conversion Price, and provide for additional adjustments based only on events from that date forward.

<sup>38</sup> Remove this sentence if the Series A Preferred Stock is not redeemable.

upon such conversion shall be determined on the basis of the total number of shares of Series A Preferred Stock the holder is at the time converting into Common Stock and the aggregate number of shares of Common Stock issuable upon such conversion.

#### 4.3 Mechanics of Conversion.

4.3.1 Notice of Conversion. In order for a holder of Series A Preferred Stock to voluntarily convert shares of Series A Preferred Stock into shares of Common Stock, such holder shall surrender the certificate or certificates for such shares of Series A Preferred Stock (or, if such registered holder alleges that such certificate has been lost, stolen or destroyed, a lost certificate affidavit and agreement reasonably acceptable to the Corporation to indemnify the Corporation against any claim that may be made against the Corporation on account of the alleged loss, theft or destruction of such certificate), at the office of the transfer agent for the Series A Preferred Stock (or at the principal office of the Corporation if the Corporation serves as its own transfer agent), together with written notice that such holder elects to convert all or any number of the shares of the Series A Preferred Stock represented by such certificate or certificates and, if applicable, any event on which such conversion is contingent. Such notice shall state such holder's name or the names of the nominees in which such holder wishes the certificate or certificates for shares of Common Stock to be issued. If required by the Corporation, certificates surrendered for conversion shall be endorsed or accompanied by a written instrument or instruments of transfer, in form satisfactory to the Corporation, duly executed by the registered holder or his, her or its attorney duly authorized in writing. The close of business on the date of receipt by the transfer agent (or by the Corporation if the Corporation serves as its own transfer agent) of such certificates (or lost certificate affidavit and agreement) and notice shall be the time of conversion (the "**Conversion Time**"), and the shares of Common Stock issuable upon conversion of the shares represented by such certificate shall be deemed to be outstanding of record as of such date. The Corporation shall, as soon as practicable after the Conversion Time, (i) issue and deliver to such holder of Series A Preferred Stock, or to his, her or its nominees, a certificate or certificates for the number of full shares of Common Stock issuable upon such conversion in accordance with the provisions hereof and a certificate for the number (if any) of the shares of Series A Preferred Stock represented by the surrendered certificate that were not converted into Common Stock, (ii) pay in cash such amount as provided in Subsection 4.2 in lieu of any fraction of a share of Common Stock otherwise issuable upon such conversion and (iii) pay all declared but unpaid dividends on the shares of Series A Preferred Stock converted.

4.3.2 Reservation of Shares. The Corporation shall at all times when the Series A Preferred Stock shall be outstanding, reserve and keep available out of its authorized but unissued capital stock, for the purpose of effecting the conversion of the Series A Preferred Stock, such number of its duly authorized shares of Common Stock as shall from time to time be sufficient to effect the conversion of all outstanding Series A Preferred Stock; and if at any time the number of authorized but unissued shares of Common Stock shall not be sufficient to effect the conversion of all then outstanding shares of the Series A Preferred Stock, the Corporation shall take such corporate action as may be necessary to increase its authorized but unissued shares of Common Stock to such number of shares as shall be sufficient for such purposes, including, without limitation, engaging in best efforts to obtain the requisite stockholder approval of any necessary amendment to the Certificate of Incorporation. Before taking any action which would cause an adjustment reducing the Series A Conversion Price

below the then par value of the shares of Common Stock issuable upon conversion of the Series A Preferred Stock, the Corporation will take any corporate action which may, in the opinion of its counsel, be necessary in order that the Corporation may validly and legally issue fully paid and nonassessable shares of Common Stock at such adjusted Series A Conversion Price.

4.3.3 Effect of Conversion. All shares of Series A Preferred Stock which shall have been surrendered for conversion as herein provided shall no longer be deemed to be outstanding and all rights with respect to such shares shall immediately cease and terminate at the Conversion Time, except only the right of the holders thereof to receive shares of Common Stock in exchange therefor, to receive payment in lieu of any fraction of a share otherwise issuable upon such conversion as provided in Subsection 4.2 and to receive payment of any dividends declared but unpaid thereon.<sup>39</sup> Any shares of Series A Preferred Stock so converted shall be retired and cancelled and may not be reissued as shares of such series, and the Corporation may thereafter take such appropriate action (without the need for stockholder action) as may be necessary to reduce the authorized number of shares of Series A Preferred Stock accordingly.

4.3.4 No Further Adjustment. Upon any such conversion, no adjustment to the Series A Conversion Price shall be made for any declared but unpaid dividends on the Series A Preferred Stock surrendered for conversion or on the Common Stock delivered upon conversion.

4.3.5 Taxes. The Corporation shall pay any and all issue and other similar taxes that may be payable in respect of any issuance or delivery of shares of Common Stock upon conversion of shares of Series A Preferred Stock pursuant to this Section 4. The Corporation shall not, however, be required to pay any tax which may be payable in respect of any transfer involved in the issuance and delivery of shares of Common Stock in a name other than that in which the shares of Series A Preferred Stock so converted were registered, and no such issuance or delivery shall be made unless and until the person or entity requesting such issuance has paid to the Corporation the amount of any such tax or has established, to the satisfaction of the Corporation, that such tax has been paid.

#### 4.4 Adjustments to Series A Conversion Price for Diluting Issues.

4.4.1 Special Definitions. For purposes of this Article Fourth, the following definitions shall apply:

(a) **“Option”** shall mean rights, options or warrants to subscribe for, purchase or otherwise acquire Common Stock or Convertible Securities.

(b) **“Series A Original Issue Date”** shall mean the date on which the first share of Series A Preferred Stock was issued.

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<sup>39</sup> Some investors will insist that, upon conversion, all declared but unpaid dividends (and, if the Series A Preferred Stock is entitled to accruing dividends, all accrued dividends, whether or not declared) be paid in additional shares of Common Stock rather than in cash. Assuming that the Series A Preferred Stock is “preferred stock” for purposes of Section 305 of the Internal Revenue Code, the issuance of additional shares of Common Stock in payment of accrued but unpaid dividends will likely be deemed to be a taxable stock dividend to the extent of the Corporation’s current and accumulated earnings and profits.

(c) “**Convertible Securities**” shall mean any evidences of indebtedness, shares or other securities directly or indirectly convertible into or exchangeable for Common Stock, but excluding Options.

(d) “**Additional Shares of Common Stock**” shall mean all shares of Common Stock issued (or, pursuant to Subsection 4.4.3 below, deemed to be issued) by the Corporation after the Series A Original Issue Date, other than (1) the following shares of Common Stock and (2) shares of Common Stock deemed issued pursuant to the following Options and Convertible Securities (clauses (1) and (2), collectively, “**Exempted Securities**”):

- (i) shares of Common Stock, Options or Convertible Securities issued as a dividend or distribution on Series A Preferred Stock;
- (ii) shares of Common Stock, Options or Convertible Securities issued by reason of a dividend, stock split, split-up or other distribution on shares of Common Stock that is covered by Subsection 4.5, 4.6, 4.7 or 4.8;
- (iii) shares of Common Stock or Options issued to employees or directors of, or consultants or advisors to, the Corporation or any of its subsidiaries pursuant to a plan, agreement or arrangement approved by the Board of Directors of the Corporation [, including the Series A Directors][, including at least one Series A Director]<sup>40,41</sup> [or]
- (iv) shares of Common Stock or Convertible Securities actually issued upon the exercise of Options or shares of Common Stock actually issued upon the conversion or exchange of Convertible Securities, in each case provided such issuance is pursuant to the terms of such Option or Convertible Security[.][; or]

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<sup>40</sup> See footnote 34.

<sup>41</sup> Alternative provision: (iii) up to [\_\_\_\_\_] shares of Common Stock, including Options therefor (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization affecting such shares), issued to employees or directors of, or consultants or advisors to, the Corporation or any of its subsidiaries pursuant to the [\_\_\_\_\_] Plan of the Corporation, whether issued before or after the Series A Original Issue Date (provided that any Options for such shares that expire or terminate unexercised or any restricted stock repurchased by the Corporation at cost shall not be counted toward such maximum number unless and until such shares are regranted as new stock grants (or as new Options) pursuant to the terms of any such plan, agreement or arrangement).



- (v) [shares of Common Stock, Options or Convertible Securities issued to banks, equipment lessors or other financial institutions, or to real property lessors, pursuant to a debt financing, equipment leasing or real property leasing transaction approved by the Board of Directors of the Corporation [, including the Series A Directors][, including at least one Series A Director]<sup>42</sup>[that do not exceed an aggregate of [ ] shares of Common Stock (including shares underlying (directly or indirectly) any such Options or Convertible Securities)]].]; or]
- (vi) [shares of Common Stock, Options or Convertible Securities issued to suppliers or third party service providers in connection with the provision of goods or services pursuant to transactions approved by the Board of Directors of the Corporation [, including the Series A Directors][, including at least one Series A Director]<sup>43</sup>[that do not exceed an aggregate of [ ] shares of Common Stock (including shares underlying (directly or indirectly) any such Options or Convertible Securities)]].]; or]
- (vii) [shares of Common Stock, Options or Convertible Securities issued pursuant to the acquisition of another corporation by the Corporation by merger, purchase of substantially all of the assets or other reorganization or to a joint venture agreement, provided, that such issuances are approved by the Board of Directors of the Corporation [, including the Series A Directors][, including at least one Series A Director]<sup>44</sup>[that do not exceed an aggregate of [ ] shares of Common Stock (including shares underlying (directly or indirectly) any such Options or Convertible Securities)]].]; or]

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<sup>42</sup> See footnote 34.

<sup>43</sup> See footnote 34.

<sup>44</sup> See footnote 34.

- (viii) [shares of Common Stock, Options or Convertible Securities issued in connection with sponsored research, collaboration, technology license, development, OEM, marketing or other similar agreements or strategic partnerships approved by the Board of Directors of the Corporation [, including the Series A Directors][, including at least one Series A Director]<sup>45</sup>[that do not exceed an aggregate of [\_\_\_\_\_] shares of Common Stock (including shares underlying (directly or indirectly) any such Options or Convertible Securities)]]].

4.4.2 No Adjustment of Series A Conversion Price. No adjustment in the Series A Conversion Price shall be made as the result of the issuance or deemed issuance of Additional Shares of Common Stock if the Corporation receives written notice from the holders of at least [*specify percentage*] of the then outstanding shares of Series A Preferred Stock agreeing that no such adjustment shall be made as the result of the issuance or deemed issuance of such Additional Shares of Common Stock.

4.4.3 Deemed Issue of Additional Shares of Common Stock.

(a) If the Corporation at any time or from time to time after the Series A Original Issue Date shall issue any Options or Convertible Securities (excluding Options or Convertible Securities which are themselves Exempted Securities) or shall fix a record date for the determination of holders of any class of securities entitled to receive any such Options or Convertible Securities, then the maximum number of shares of Common Stock (as set forth in the instrument relating thereto, assuming the satisfaction of any conditions to exercisability, convertibility or exchangeability but without regard to any provision contained therein for a subsequent adjustment of such number) issuable upon the exercise of such Options or, in the case of Convertible Securities and Options therefor, the conversion or exchange of such Convertible Securities, shall be deemed to be Additional Shares of Common Stock issued as of the time of such issue or, in case such a record date shall have been fixed, as of the close of business on such record date.

(b) If the terms of any Option or Convertible Security, the issuance of which resulted in an adjustment to the Series A Conversion Price pursuant to the terms of Subsection 4.4.4, are revised as a result of an amendment to such terms or any other adjustment pursuant to the provisions of such Option or Convertible Security (but excluding automatic adjustments to such terms pursuant to anti-dilution or similar provisions of such Option or Convertible Security)<sup>46</sup> to provide for either (1) any increase or decrease in the number

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<sup>45</sup> See footnote 34.

<sup>46</sup> The reason for this parenthetical is that an automatic change in another security pursuant to its anti-dilution provisions would cause an automatic adjustment pursuant to this provision. If the adjustment pursuant to this provision then causes another automatic change in the other security, it is possible that the second change in the other security can cause a second change pursuant to this provision, which causes a third change to the other (Footnote continued on next page)

of shares of Common Stock issuable upon the exercise, conversion and/or exchange of any such Option or Convertible Security or (2) any increase or decrease in the consideration payable to the Corporation upon such exercise, conversion and/or exchange, then, effective upon such increase or decrease becoming effective, the Series A Conversion Price computed upon the original issue of such Option or Convertible Security (or upon the occurrence of a record date with respect thereto) shall be readjusted to such Series A Conversion Price as would have obtained had such revised terms been in effect upon the original date of issuance of such Option or Convertible Security. Notwithstanding the foregoing, no readjustment pursuant to this clause (b) shall have the effect of increasing the Series A Conversion Price to an amount which exceeds the lower of (i) the Series A Conversion Price in effect immediately prior to the original adjustment made as a result of the issuance of such Option or Convertible Security, or (ii) the Series A Conversion Price that would have resulted from any issuances of Additional Shares of Common Stock (other than deemed issuances of Additional Shares of Common Stock as a result of the issuance of such Option or Convertible Security) between the original adjustment date and such readjustment date.

(c) If the terms of any Option or Convertible Security (excluding Options or Convertible Securities which are themselves Exempted Securities), the issuance of which did not result in an adjustment to the Series A Conversion Price pursuant to the terms of Subsection 4.4.4 (either because the consideration per share (determined pursuant to Subsection 4.4.5) of the Additional Shares of Common Stock subject thereto was equal to or greater than the Series A Conversion Price then in effect, or because such Option or Convertible Security was issued before the Series A Original Issue Date), are revised after the Series A Original Issue Date as a result of an amendment to such terms or any other adjustment pursuant to the provisions of such Option or Convertible Security (but excluding automatic adjustments to such terms pursuant to anti-dilution or similar provisions of such Option or Convertible Security)<sup>47</sup> to provide for either (1) any increase in the number of shares of Common Stock issuable upon the exercise, conversion or exchange of any such Option or Convertible Security or (2) any decrease in the consideration payable to the Corporation upon such exercise, conversion or exchange, then such Option or Convertible Security, as so amended or adjusted,

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security and then a third adjustment pursuant to this provision, and on and on. This form does not provide for adjustment to the Series A Conversion Price as a result of anti-dilution adjustments to the terms of Options or Convertible Securities, because of the complexity involved in such calculations, and because the dilutive event triggering the adjustment to the terms of the Option or Convertible Security would presumably also trigger an adjustment to the Series A Conversion Price under the terms Subsection 4.4.4 (thus obviating the need to provide for an adjustment to the Series A Conversion Price as a result of an anti-dilution adjustment to the terms of the Option or Convertible Security).

<sup>47</sup> The reason for this parenthetical is that an automatic change in another security pursuant to its anti-dilution provisions would cause an automatic adjustment pursuant to this provision. If the adjustment pursuant to this provision then causes another automatic change in the other security, it is possible that the second change in the other security can cause a second change pursuant to this provision, which causes a third change to the other security and then a third adjustment pursuant to this provision, and on and on. This form does not provide for adjustment to the Series A Conversion Price as a result of anti-dilution adjustments to the terms of Options or Convertible Securities, because of the complexity involved in such calculations, and because the dilutive event triggering the adjustment to the terms of the Option or Convertible Security would presumably also trigger an adjustment to the Series A Conversion Price under the terms Subsection 4.4.4 (thus obviating the need to provide for an adjustment to the Series A Conversion Price as a result of an anti-dilution adjustment to the terms of the Option or Convertible Security).

and the Additional Shares of Common Stock subject thereto (determined in the manner provided in Subsection 4.4.3(a) shall be deemed to have been issued effective upon such increase or decrease becoming effective.

(d) Upon the expiration or termination of any unexercised Option or unconverted or unexchanged Convertible Security (or portion thereof) which resulted (either upon its original issuance or upon a revision of its terms) in an adjustment to the Series A Conversion Price pursuant to the terms of Subsection 4.4.4, the Series A Conversion Price shall be readjusted to such Series A Conversion Price as would have obtained had such Option or Convertible Security (or portion thereof) never been issued.

(e) If the number of shares of Common Stock issuable upon the exercise, conversion and/or exchange of any Option or Convertible Security, or the consideration payable to the Corporation upon such exercise, conversion and/or exchange, is calculable at the time such Option or Convertible Security is issued or amended but is subject to adjustment based upon subsequent events, any adjustment to the Series A Conversion Price provided for in this Subsection 4.4.3 shall be effected at the time of such issuance or amendment based on such number of shares or amount of consideration without regard to any provisions for subsequent adjustments (and any subsequent adjustments shall be treated as provided in clauses (b) and (c) of this Subsection 4.4.3). If the number of shares of Common Stock issuable upon the exercise, conversion and/or exchange of any Option or Convertible Security, or the consideration payable to the Corporation upon such exercise, conversion and/or exchange, cannot be calculated at all at the time such Option or Convertible Security is issued or amended, any adjustment to the Series A Conversion Price that would result under the terms of this Subsection 4.4.3 at the time of such issuance or amendment shall instead be effected at the time such number of shares and/or amount of consideration is first calculable (even if subject to subsequent adjustments), assuming for purposes of calculating such adjustment to the Series A Conversion Price that such issuance or amendment took place at the time such calculation can first be made.

*[Use the following Subsection 4.4.4 if the terms sheet calls for a broad-based weighted average anti-dilution provision]*

4.4.4 Adjustment of Series A Conversion Price Upon Issuance of Additional Shares of Common Stock.<sup>48</sup> In the event the Corporation shall at any time after the Series A Original Issue Date issue Additional Shares of Common Stock (including Additional Shares of Common Stock deemed to be issued pursuant to Subsection 4.4.3), without

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<sup>48</sup> This subsection represents a typical “broad-based weighted average” anti-dilution provision. Broad-based anti-dilution is more founder-friendly than a “narrow-based” anti-dilution formula. Whether an anti-dilution provision is broad or narrow is determined by how broad or narrow is the formula (set forth in clause (c) of this subsection) for calculating the number of outstanding shares of Common Stock. An even broader formula would include in that calculation all shares reserved under stock plans, whether or not subject to outstanding options (on the theory that those shares are generally included when translating the “pre-money valuation” agreed between the Corporation and the investors to a per share purchase price for the financing). In contrast, a narrower formula might include in the calculation of outstanding shares only those shares of Common Stock that are actually outstanding (i.e., excluding shares of Common Stock issuable on conversion of options, warrants and, potentially, even the Preferred Stock itself). While narrow-based anti-dilution formulas are more investor-friendly, the most investor-friendly category of anti-dilution protection is a “full ratchet” anti-dilution.

consideration or for a consideration per share less than the Series A Conversion Price in effect immediately prior to such issue, then the Series A Conversion Price shall be reduced, concurrently with such issue, to a price (calculated to the nearest [one-hundredth of a cent]) determined in accordance with the following formula:

$$CP_2 = CP_1 * (A + B) \div (A + C).$$

For purposes of the foregoing formula, the following definitions shall apply:

(a) “CP<sub>2</sub>” shall mean the Series A Conversion Price in effect immediately after such issue of Additional Shares of Common Stock

(b) “CP<sub>1</sub>” shall mean the Series A Conversion Price in effect immediately prior to such issue of Additional Shares of Common Stock;

(c) “A” shall mean the number of shares of Common Stock outstanding immediately prior to such issue of Additional Shares of Common Stock (treating for this purpose as outstanding all shares of Common Stock issuable upon exercise of Options outstanding immediately prior to such issue or upon conversion or exchange of Convertible Securities (including the Series A Preferred Stock) outstanding (assuming exercise of any outstanding Options therefor) immediately prior to such issue);

(d) “B” shall mean the number of shares of Common Stock that would have been issued if such Additional Shares of Common Stock had been issued at a price per share equal to CP<sub>1</sub> (determined by dividing the aggregate consideration received by the Corporation in respect of such issue by CP<sub>1</sub>); and

(e) “C” shall mean the number of such Additional Shares of Common Stock issued in such transaction.

*[Use the following Subsection 4.4.4 if the term sheet calls for a full ratchet anti-dilution provision]*

4.4.4 Adjustment of Series A Conversion Price Upon Issuance of Additional Shares of Common Stock. In the event the Corporation shall at any time after the Series A Original Issue Date [and prior to [*specify end date if one was negotiated*]] issue Additional Shares of Common Stock (including Additional Shares of Common Stock deemed to be issued pursuant to Subsection 4.4.3), without consideration or for a consideration per share less than the applicable Series A Conversion Price in effect immediately prior to such issue, then the Series A Conversion Price shall be reduced, concurrently with such issue, to the consideration per share received by the Corporation for such issue or deemed issue of the Additional Shares of Common Stock; provided that if such issuance or deemed issuance was without consideration, then the Corporation shall be deemed to have received an aggregate of [\$.001] of consideration for all such Additional Shares of Common Stock issued or deemed to be issued.

4.4.5 Determination of Consideration. For purposes of this Subsection 4.4, the consideration received by the Corporation for the issue of any Additional Shares of Common Stock shall be computed as follows:

(a) Cash and Property: Such consideration shall:

- (i) insofar as it consists of cash, be computed at the aggregate amount of cash received by the Corporation, excluding amounts paid or payable for accrued interest;
- (ii) insofar as it consists of property other than cash, be computed at the fair market value thereof at the time of such issue, as determined in good faith by the Board of Directors of the Corporation; and
- (iii) in the event Additional Shares of Common Stock are issued together with other shares or securities or other assets of the Corporation for consideration which covers both, be the proportion of such consideration so received, computed as provided in clauses (i) and (ii) above, as determined in good faith by the Board of Directors of the Corporation.

(b) Options and Convertible Securities. The consideration per share received by the Corporation for Additional Shares of Common Stock deemed to have been issued pursuant to Subsection 4.4.3, relating to Options and Convertible Securities, shall be determined by dividing

the total amount, if any, received or receivable by the Corporation as consideration for the issue of such Options or Convertible Securities, plus the minimum aggregate amount of additional consideration (as set forth in the instruments relating thereto, without regard to any provision contained therein for a subsequent adjustment of such consideration) payable to the Corporation upon the exercise of such Options or the conversion or exchange of such Convertible Securities, or in the case of Options for Convertible Securities, the exercise of such Options for Convertible Securities and the conversion or exchange of such Convertible Securities, by

- (i) the maximum number of shares of Common Stock (as set forth in the instruments relating thereto, without regard to any provision contained therein for a subsequent adjustment of such number) issuable upon the exercise of such Options or the conversion or exchange of such Convertible Securities, or in the case of Options for Convertible Securities, the exercise of such Options for Convertible Securities and the conversion or exchange of such Convertible Securities.

4.4.6 Multiple Closing Dates. In the event the Corporation shall issue on more than one date Additional Shares of Common Stock that are a part of one transaction or a series of related transactions and that would result in an adjustment to the Series A Conversion Price pursuant to the terms of Subsection 4.4.4 [, and such issuance dates occur within a period of no more than [90] days from the first such issuance to the final such issuance,] then, upon the final such issuance, the Series A Conversion Price shall be readjusted to give effect to all such issuances as if they occurred on the date of the first such issuance (and without giving effect to any additional adjustments as a result of any such subsequent issuances within such period).

4.5 Adjustment for Stock Splits and Combinations.<sup>49</sup> If the Corporation shall at any time or from time to time after the Series A Original Issue Date effect a subdivision of the outstanding Common Stock, the Series A Conversion Price in effect immediately before that subdivision shall be proportionately decreased so that the number of shares of Common Stock issuable on conversion of each share of such series shall be increased in proportion to such increase in the aggregate number of shares of Common Stock outstanding. If the Corporation shall at any time or from time to time after the Series A Original Issue Date combine the outstanding shares of Common Stock, the Series A Conversion Price in effect immediately before the combination shall be proportionately increased so that the number of shares of Common Stock issuable on conversion of each share of such series shall be decreased in proportion to such decrease in the aggregate number of shares of Common Stock outstanding. Any adjustment under this subsection shall become effective at the close of business on the date the subdivision or combination becomes effective.

4.6 Adjustment for Certain Dividends and Distributions. In the event the Corporation at any time or from time to time after the Series A Original Issue Date shall make or issue, or fix a record date for the determination of holders of Common Stock entitled to receive, a dividend or other distribution payable on the Common Stock in additional shares of Common Stock, then and in each such event the Series A Conversion Price in effect immediately before such event shall be decreased as of the time of such issuance or, in the event such a record date shall have been fixed, as of the close of business on such record date, by multiplying the Series A Conversion Price then in effect by a fraction:

(1) the numerator of which shall be the total number of shares of Common Stock issued and outstanding immediately prior to the time of such issuance or the close of business on such record date, and

(2) the denominator of which shall be the total number of shares of Common Stock issued and outstanding immediately prior to the time of such issuance or the close of business on such record date plus the number of shares of Common Stock issuable in payment of such dividend or distribution.

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<sup>49</sup> This subsection and the subsections that follow do not provide for any adjustment to the Series A Conversion Price in the event of stock splits, etc. affecting the Series A Preferred Stock, because those adjustments are covered by the definition of Series A Original Issue Price, which automatically adjusts the numerator of the conversion ratio.

Notwithstanding the foregoing, (a) if such record date shall have been fixed and such dividend is not fully paid or if such distribution is not fully made on the date fixed therefor, the Series A Conversion Price shall be recomputed accordingly as of the close of business on such record date and thereafter the Series A Conversion Price shall be adjusted pursuant to this subsection as of the time of actual payment of such dividends or distributions; and (b) that no such adjustment shall be made if the holders of Series A Preferred Stock simultaneously receive a dividend or other distribution of shares of Common Stock in a number equal to the number of shares of Common Stock as they would have received if all outstanding shares of Series A Preferred Stock had been converted into Common Stock on the date of such event.

4.7 Adjustments for Other Dividends and Distributions. In the event the Corporation at any time or from time to time after the Series A Original Issue Date shall make or issue, or fix a record date for the determination of holders of Common Stock entitled to receive, a dividend or other distribution payable in securities of the Corporation (other than a distribution of shares of Common Stock in respect of outstanding shares of Common Stock) or in other property and the provisions of Section 1 do not apply to such dividend or distribution, then and in each such event the holders of Series A Preferred Stock shall receive, simultaneously with the distribution to the holders of Common Stock, a dividend or other distribution of such securities or other property in an amount equal to the amount of such securities or other property as they would have received if all outstanding shares of Series A Preferred Stock had been converted into Common Stock on the date of such event.<sup>50</sup>

4.8 Adjustment for Merger or Reorganization, etc. Subject to the provisions of Subsection 2.3, if there shall occur any reorganization, recapitalization, reclassification, consolidation or merger involving the Corporation in which the Common Stock (but not the Series A Preferred Stock) is converted into or exchanged for securities, cash or other property (other than a transaction covered by Subsections 4.4, 4.6 or 4.7), then, following any such reorganization, recapitalization, reclassification, consolidation or merger, each share of Series A Preferred Stock shall thereafter be convertible in lieu of the Common Stock into which it was convertible prior to such event into the kind and amount of securities, cash or other property which a holder of the number of shares of Common Stock of the Corporation issuable upon conversion of one share of Series A Preferred Stock immediately prior to such reorganization, recapitalization, reclassification, consolidation or merger would have been entitled to receive pursuant to such transaction; and, in such case, appropriate adjustment (as determined in good faith by the Board of Directors of the Corporation) shall be made in the application of the provisions in this Section 4 with respect to the rights and interests thereafter of

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<sup>50</sup> Alternative provision: add the following after “in each such event” in place of the current text – provision shall be made so that the holders of the Series A Preferred Stock shall receive upon conversion thereof, in addition to the number of shares of Common Stock receivable thereupon, the kind and amount of securities of the Corporation, cash or other property which they would have been entitled to receive had the Series A Preferred Stock been converted into Common Stock on the date of such event and had they thereafter, during the period from the date of such event to and including the conversion date, retained such securities receivable by them as aforesaid during such period, giving application to all adjustments called for during such period under this paragraph with respect to the rights of the holders of the Series A Preferred Stock; provided, however, that no such provision shall be made if the holders of Series A Preferred Stock receive, simultaneously with the distribution to the holders of Common Stock, a dividend or other distribution of such securities, cash or other property in an amount equal to the amount of such securities, cash or other property as they would have received if all outstanding shares of Series A Preferred Stock had been converted into Common Stock on the date of such event.



the holders of the Series A Preferred Stock, to the end that the provisions set forth in this Section 4 (including provisions with respect to changes in and other adjustments of the Series A Conversion Price) shall thereafter be applicable, as nearly as reasonably may be, in relation to any securities or other property thereafter deliverable upon the conversion of the Series A Preferred Stock. [For the avoidance of doubt, nothing in this Subsection 4.8 shall be construed as preventing the holders of Series A Preferred Stock from seeking any appraisal rights to which they are otherwise entitled under the DGCL in connection with a merger triggering an adjustment hereunder, nor shall this Subsection 4.8 be deemed conclusive evidence of the fair value of the shares of Series A Preferred Stock in any such appraisal proceeding.]<sup>51</sup>

4.9 Certificate as to Adjustments. Upon the occurrence of each adjustment or readjustment of the Series A Conversion Price pursuant to this Section 4, the Corporation at its expense shall, as promptly as reasonably practicable but in any event not later than [10] days thereafter, compute such adjustment or readjustment in accordance with the terms hereof and furnish to each holder of Series A Preferred Stock a certificate setting forth such adjustment or readjustment (including the kind and amount of securities, cash or other property into which the Series A Preferred Stock is convertible) and showing in detail the facts upon which such adjustment or readjustment is based. The Corporation shall, as promptly as reasonably practicable after the written request at any time of any holder of Series A Preferred Stock (but in any event not later than [10] days thereafter), furnish or cause to be furnished to such holder a certificate setting forth (i) the Series A Conversion Price then in effect, and (ii) the number of shares of Common Stock and the amount, if any, of other securities, cash or property which then would be received upon the conversion of Series A Preferred Stock.

4.10 Notice of Record Date. In the event:

(a) the Corporation shall take a record of the holders of its Common Stock (or other capital stock or securities at the time issuable upon conversion of the Series A Preferred Stock) for the purpose of entitling or enabling them to receive any dividend or other distribution, or to receive any right to subscribe for or purchase any shares of capital stock of any class or any other securities, or to receive any other security; or

(b) of any capital reorganization of the Corporation, any reclassification of the Common Stock of the Corporation, or any Deemed Liquidation Event; or

(c) of the voluntary or involuntary dissolution, liquidation or winding-up of the Corporation,

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<sup>51</sup> In several recent Delaware cases involving mergers that were *not* treated as a liquidation under the Certificate of Incorporation, the Court of Chancery construed anti-destruction language of the type found in Section 4.8 as capping the value of the Preferred Stock in an appraisal proceeding. See *In re Appraisal of Metromedia International Group, Inc.*, Case No. C.A. 3351-CC (Del. Ch. Ct. 4/16/09). Anti-destruction provisions such as those above focus on the conversion rights of the Series A Preferred Stock. An appraisal, by contrast, could theoretically account for the liquidation, dividend and other preferences of the Series A Preferred Stock. In this Model Charter many mergers are treated as liquidations; the bracketed language provides the Series A investors protection in the case of a merger that does not trigger payment of the liquidation preference.

then, and in each such case, the Corporation will send or cause to be sent to the holders of the Series A Preferred Stock a notice specifying, as the case may be, (i) the record date for such dividend, distribution or right, and the amount and character of such dividend, distribution or right, or (ii) the effective date on which such reorganization, reclassification, consolidation, merger, transfer, dissolution, liquidation or winding-up is proposed to take place, and the time, if any is to be fixed, as of which the holders of record of Common Stock (or such other capital stock or securities at the time issuable upon the conversion of the Series A Preferred Stock) shall be entitled to exchange their shares of Common Stock (or such other capital stock or securities) for securities or other property deliverable upon such reorganization, reclassification, consolidation, merger, transfer, dissolution, liquidation or winding-up, and the amount per share and character of such exchange applicable to the Series A Preferred Stock and the Common Stock. Such notice shall be sent at least [10] days prior to the record date or effective date for the event specified in such notice.

## 5. Mandatory Conversion.

5.1 Trigger Events. Upon either (a) the closing of the sale of shares of Common Stock to the public at a price of at least \$[\_\_\_\_\_] per share (subject to appropriate adjustment in the event of any stock dividend, stock split, combination or other similar recapitalization with respect to the Common Stock), in a firm-commitment underwritten public offering pursuant to an effective registration statement under the Securities Act of 1933, as amended, resulting in at least \$[\_\_\_\_\_] of [gross] proceeds [, net of the underwriting discount and commissions,] to the Corporation or (b) the date and time, or the occurrence of an event, specified by vote or written consent of the holders of at least [*specify percentage*] of the then outstanding shares of Series A Preferred Stock (the time of such closing or the date and time specified or the time of the event specified in such vote or written consent is referred to herein as the “**Mandatory Conversion Time**”), (i) all outstanding shares of Series A Preferred Stock shall automatically be converted into shares of Common Stock, at the then effective conversion rate and (ii) such shares may not be reissued by the Corporation.

5.2 Procedural Requirements. All holders of record of shares of Series A Preferred Stock shall be sent written notice of the Mandatory Conversion Time and the place designated for mandatory conversion of all such shares of Series A Preferred Stock pursuant to this Section 5. Such notice need not be sent in advance of the occurrence of the Mandatory Conversion Time. Upon receipt of such notice, each holder of shares of Series A Preferred Stock shall surrender his, her or its certificate or certificates for all such shares (or, if such holder alleges that such certificate has been lost, stolen or destroyed, a lost certificate affidavit and agreement reasonably acceptable to the Corporation to indemnify the Corporation against any claim that may be made against the Corporation on account of the alleged loss, theft or destruction of such certificate) to the Corporation at the place designated in such notice. If so required by the Corporation, certificates surrendered for conversion shall be endorsed or accompanied by written instrument or instruments of transfer, in form satisfactory to the Corporation, duly executed by the registered holder or by his, her or its attorney duly authorized in writing. All rights with respect to the Series A Preferred Stock converted pursuant to Subsection 5.1, including the rights, if any, to receive notices and vote (other than as a holder of Common Stock), will terminate at the Mandatory Conversion Time (notwithstanding the failure of the holder or holders thereof to surrender the certificates at or prior to such time), except only the rights of the holders thereof, upon surrender of their certificate or certificates (or lost

certificate affidavit and agreement) therefor, to receive the items provided for in the next sentence of this Subsection 5.2. As soon as practicable after the Mandatory Conversion Time and the surrender of the certificate or certificates (or lost certificate affidavit and agreement) for Series A Preferred Stock, the Corporation shall issue and deliver to such holder, or to his, her or its nominees, a certificate or certificates for the number of full shares of Common Stock issuable on such conversion in accordance with the provisions hereof, together with cash as provided in Subsection 4.2 in lieu of any fraction of a share of Common Stock otherwise issuable upon such conversion and the payment of any declared but unpaid dividends on the shares of Series A Preferred Stock converted. Such converted Series A Preferred Stock shall be retired and cancelled and may not be reissued as shares of such series, and the Corporation may thereafter take such appropriate action (without the need for stockholder action) as may be necessary to reduce the authorized number of shares of Series A Preferred Stock accordingly.

*[Use the following Section 5A if the Term Sheet calls for a pay-to-play provision where the penalty is conversion into Common Stock]<sup>52</sup>*

#### 5A. Special Mandatory Conversion.

5A.1. Trigger Event. In the event that any holder of shares of Series A Preferred Stock does not participate in a Qualified Financing (as defined below) by purchasing in the aggregate, in such Qualified Financing and within the time period specified by the Corporation (provided that the Corporation has sent to each holder of Series A Preferred Stock at least 10 days written notice of, and the opportunity to purchase its Pro Rata Amount (as defined below) of, the Qualified Financing), such holder's Pro Rata Amount, [then each share] [then the Applicable Portion (as defined below) of the shares] of Series A Preferred Stock held by such holder shall automatically, and without any further action on the part of such holder, be converted into shares of Common Stock at the Series A Conversion Price in effect immediately prior to the consummation of such Qualified Financing, effective upon, subject to, and concurrently with, the consummation of the Qualified Financing. For purposes of determining the number of shares of Series A Preferred Stock owned by a holder, and for determining the number of Offered Securities (as defined below) a holder of Series A Preferred Stock has purchased in a Qualified Financing, all shares of Series A Preferred Stock held by Affiliates (as defined below) of such holder shall be aggregated with such holder's shares and all Offered Securities purchased by Affiliates of such holder shall be aggregated with the Offered Securities purchased by such holder (provided that no shares or securities shall be attributed to more than one entity or person within any such group of affiliated entities or persons). Such conversion is referred to as a "**Special Mandatory Conversion.**"<sup>53</sup>

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<sup>52</sup> Structuring the pay-to-play provision so that the Series A Preferred Stock of a non-participating investor converts into Common Stock (rather than a "shadow series" of Preferred Stock as discussed in the preliminary notes under "Pay-to-Play Provision") is generally preferable, because: (1) this is a harsher penalty; (2) under Delaware law, certain charter amendments may not be effected without the approval of the holders of a majority of the outstanding shares of the new shadow series of Preferred Stock; and (3) conversion to Common Stock avoids the complexities associated with the creation of the shadow series of Preferred Stock.

<sup>53</sup> Careful consideration must be given to whether shares of Series A Preferred Stock converted upon a Special Mandatory Conversion should lose the contractual rights provided under the various ancillary agreements typically involved in a Preferred Stock financing (e.g., registration rights, pre-emptive rights, etc.).

5A.2. Procedural Requirements. Upon a Special Mandatory Conversion, each holder of shares of Series A Preferred Stock converted pursuant to Subsection 5A.1 shall be sent written notice of such Special Mandatory Conversion and the place designated for mandatory conversion of all such shares of Series A Preferred Stock pursuant to this Section 5A. Upon receipt of such notice, each holder of such shares of Series A Preferred Stock shall surrender his, her or its certificate or certificates for all such shares (or, if such holder alleges that such certificate has been lost, stolen or destroyed, a lost certificate affidavit and agreement reasonably acceptable to the Corporation to indemnify the Corporation against any claim that may be made against the Corporation on account of the alleged loss, theft or destruction of such certificate) to the Corporation at the place designated in such notice. If so required by the Corporation, certificates surrendered for conversion shall be endorsed or accompanied by written instrument or instruments of transfer, in form satisfactory to the Corporation, duly executed by the registered holder or by his, her or its attorney duly authorized in writing. All rights with respect to the Series A Preferred Stock converted pursuant to Subsection 5A.1, including the rights, if any, to receive notices and vote (other than as a holder of Common Stock), will terminate at the time of the Special Mandatory Conversion (notwithstanding the failure of the holder or holders thereof to surrender the certificates for such shares at or prior to such time), except only the rights of the holders thereof, upon surrender of their certificate or certificates therefor (or lost certificate affidavit and agreement), to receive the items provided for in the next sentence of this Subsection 5A.2. As soon as practicable after the Special Mandatory Conversion and the surrender of the certificate or certificates (or lost certificate affidavit and agreement) for Series A Preferred Stock so converted, the Corporation shall issue and deliver to such holder, or to his, her or its nominees, a certificate or certificates for the number of full shares of Common Stock issuable on such conversion in accordance with the provisions hereof, together with cash as provided in Subsection 4.2 in lieu of any fraction of a share of Common Stock otherwise issuable upon such conversion and the payment of any declared but unpaid dividends on the shares of Series A Preferred Stock converted [and a new certificate for the number of shares, if any, of Series A Preferred Stock represented by such surrendered certificate and not converted pursuant to Subsection 5A.1].<sup>54</sup> Such converted Series A Preferred Stock shall be retired and cancelled and may not be reissued as shares of such series, and the Corporation may thereafter take such appropriate action (without the need for stockholder action) as may be necessary to reduce the authorized number of shares of Series A Preferred Stock accordingly.

5A.3. Definitions. For purposes of this Section 5A, the following definitions shall apply:

5A.3.1 “**Affiliate**” shall mean, with respect to any holder of shares of Series A Preferred Stock, any person, entity or firm which, directly or indirectly, controls, is controlled by or is under common control with such holder, including, without limitation, any entity of which the holder is a partner or member, any partner, officer, director, member or employee of such holder and any venture capital fund now or hereafter existing of which the holder is a partner or member which is controlled by or under common control with one or more general partners of such holder or shares the same management company with such holder.

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Applicable only if proportional conversion is provided for by the Certificate of Incorporation.

5A.3.2 [**“Applicable Portion”** shall mean, with respect to any holder of shares of Series A Preferred Stock, a number of shares of Series A Preferred Stock calculated by multiplying the aggregate number of shares of Series A Preferred Stock held by such holder immediately prior to a Qualified Financing by a fraction, the numerator of which is equal to the amount, if positive, by which such holder’s Pro Rata Amount exceeds the number of Offered Securities actually purchased by such holder in such Qualified Financing, and the denominator of which is equal to such holder’s Pro Rata Amount.]<sup>55</sup>

5A.3.3 **“Offered Securities”** shall mean the equity securities of the Corporation set aside by the Board of Directors of the Corporation for purchase by holders of outstanding shares of Series A Preferred Stock in connection with a Qualified Financing, and offered to such holders.

5A.3.4 **“Pro Rata Amount”** shall mean, with respect to any holder of Series A Preferred Stock, the lesser of (a) a number of Offered Securities calculated by multiplying the aggregate number of Offered Securities by a fraction, the numerator of which is equal to [the number of shares of Series A Preferred Stock owned by such holder, and the denominator of which is equal to the aggregate number of outstanding shares of Series A Preferred Stock],<sup>56</sup> or (b) the maximum number of Offered Securities that such holder is permitted by the Corporation to purchase in such Qualified Financing, after giving effect to any cutbacks or limitations established by the Board of Directors and applied on a pro rata basis to all holders of Series A Preferred Stock.

5A.3.5 **“Qualified Financing”** shall mean any transaction involving the issuance or sale of Additional Shares of Common Stock after the Series A Original Issue Date [that would result in at least \$\_\_\_\_\_ in gross proceeds to the Corporation [including by way of the conversion of any outstanding debt] [and the reduction of the Series A Conversion Price pursuant to the terms of the Certificate of Incorporation (without giving effect to the operation of Subsection 4.4.2)], unless the holders of at least [*specify percentage*] of the Series A Preferred Stock elect, by written notice sent to the Corporation at least [\_\_\_] days prior to the consummation of the Qualified Financing, that such transaction not be treated as a Qualified Financing for purposes of this Section 5A.

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<sup>55</sup> Applicable only if proportional conversion is provided for by the Certificate of Incorporation.

<sup>56</sup> Alternative: “the number of shares of outstanding Common Stock owned by such holder, and the denominator of which is equal to the aggregate number of outstanding shares of Common Stock (for the purpose of this definition, treating all shares of Common Stock issuable upon exercise of Options outstanding immediately prior to such Qualified Financing or upon conversion of Convertible Securities outstanding (assuming exercise of any outstanding Options therefor) immediately prior to such Qualified Financing as outstanding).”

## 6. Redemption.<sup>57</sup>

6.1 General. Unless prohibited by Delaware law governing distributions to stockholders, shares of Series A Preferred Stock shall be redeemed by the Corporation at a price equal to [the greater of (A)][the Series A Original Issue Price per share, plus all declared but unpaid dividends thereon]<sup>58</sup>[and (B) the Fair Market Value (determined in the manner set forth below) of a single share of Series A Preferred Stock as of the date of the Company's receipt of the Redemption Request] (the "**Redemption Price**"),<sup>59</sup> in three annual installments commencing not more than 60 days after receipt by the Corporation at any time on or after [\_\_\_\_\_], from the holders of at least [*specify percentage*] of the then outstanding shares of Series A Preferred Stock, of written notice requesting redemption of all shares of Series A Preferred Stock (the "**Redemption Request**").<sup>60</sup> Upon receipt of a

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<sup>57</sup> Redemption provisions are more common in East Coast venture transactions than in West Coast venture transactions. However, in the wake of the Delaware Chancery Court's opinion in *re Trados Inc. S'holder Litigation, Case No. C.A. 1512-CC (Del. Ch. Ct. 7/24/09)*, investors may be foregoing a substantial protection/benefit if they do not have the right to put their shares back to the company at a time when they may wish to seek the sale of the company. See footnote 29 in the Addendum of the Model Voting Agreement for a more detailed discussion of these issues.

<sup>58</sup> Replace with the following if accruing dividends are selected: "the Series A Original Issue Price per share, plus any Accruing Dividends accrued but unpaid thereon, whether or not declared, together with any other dividends declared but unpaid thereon"

<sup>59</sup> Redemption prices are sometimes fixed at the greater of the Series A Original Issue Price (plus dividends, if applicable) and the fair market value of the Series A Preferred Stock on the date of the Redemption Notice or the date of redemption. When structuring redeemable Preferred Stock, consideration should be given to Section 305(c) of the Internal Revenue Code. Section 305(c) provides that, in certain circumstances, redemption premiums on Preferred Stock are treated for tax purposes in the same manner as original issue discount on bonds. That is, redemption premiums are generally treated as being distributed to the holders of Preferred Stock over the period that the Preferred Stock is outstanding (the "Constructive Distribution Rule"). Distribution amounts for tax periods prior to redemption are determined by applying the yield to maturity (determined as the discount rate that, when used to compute the present value of the redemption price, produces an amount equal to the issue price of the Preferred Stock) to the issue price plus previously accrued amounts. If Preferred Stock is subject to either an automatic redemption or a redemption at the request of the Preferred Stock holders, the only exception to the Constructive Distribution Rule is for a redemption premium that is de minimis in amount (the "De Minimis Exception"). The De Minimis Exception applies where the amount by which the redemption price at maturity exceeds the issue price is less than one-quarter of one percent (.25%) of the redemption price multiplied by the number of complete years to maturity.

It is important to note that the Constructive Distribution Rule only applies to stock that is treated as "preferred stock" for tax purposes. Applicable Treasury Regulations under Code Section 305 indicate that a class of stock will be treated as "preferred stock" only if it has limited rights to participate in the growth of the issuer (as determined without regard to any conversion right inherent in the stock). Thus, Preferred Stock with unlimited rights to participate (a) in dividend distributions and (b) upon liquidation in excess of any stated preference (all as determined without regard to any right to convert such stock into Common Stock) will allow holders of such Preferred Stock to assert that their stock is not "preferred stock" for tax purposes. Note that even "nonparticipating" Preferred Stock can be structured in this manner by providing (as does this form) that upon liquidation of the Corporation the Preferred Stock will receive the greater of (i) its liquidation preference or (ii) the amount the holders of such Preferred Stock would receive if the proceeds were distributed to holders based on the number of shares of Common Stock into which the Preferred Stock could then be converted.

<sup>60</sup> The Corporation's accountants may take the position that, because the holders of Series A Preferred Stock have the right to force a redemption, the Preferred Stock should be reflected above the stockholders' equity section of the Corporation's balance sheet, as opposed to in the stockholders' equity section of the balance sheet. If so, it is not uncommon for a Corporation to have negative stockholders' equity. In addition, if the Series A (Footnote continued on next page)

Redemption Request, the Corporation shall apply all of its assets to any such redemption, and to no other corporate purpose, except to the extent prohibited by Delaware law governing distributions to stockholders.<sup>61</sup> [For purposes of this Subsection 6.1, the Fair Market Value of a single share of Series A Preferred Stock shall be the value of a single share of Series A Preferred Stock as mutually agreed upon by the Company and the holders of a majority of the shares of Series A Preferred Stock then outstanding, and, in the event that they are unable to reach agreement, by a third-party appraiser agreed to by the Company and the holders of a majority of the shares of Series A Preferred Stock then outstanding.]<sup>62</sup> The date of each such installment shall be referred to as a “**Redemption Date**”. On each Redemption Date, the Corporation shall redeem, on a pro rata basis in accordance with the number of shares of Series A Preferred Stock owned by each holder, that number of outstanding shares of Series A Preferred Stock determined by dividing (i) the total number of shares of Series A Preferred Stock outstanding immediately prior to such Redemption Date by (ii) the number of remaining Redemption Dates (including the Redemption Date to which such calculation applies) [; provided, however, that Excluded Shares (as such term is defined in Subsection 6.2) shall not be redeemed and shall be excluded from the calculations set forth in this sentence].<sup>63</sup> If on any Redemption Date Delaware law governing distributions to stockholders prevents the Corporation from redeeming all shares of Series A Preferred Stock to be redeemed, the Corporation shall ratably redeem the maximum number of shares that it may redeem consistent with such law, and shall redeem the remaining shares as soon as it may lawfully do so under such law.<sup>64</sup>

6.2 **Redemption Notice.** The Corporation shall send written notice of the mandatory redemption (the “**Redemption Notice**”) to each holder of record of Series A Preferred Stock not less than 40 days prior to each Redemption Date. Each Redemption Notice shall state:

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Preferred Stock is redeemable at the greater of the original purchase price and the then current fair market value, this might cause the Corporation to have to “mark to market” the redeemable Preferred Stock each quarter, which could cause significant practical and accounting complexities for the Corporation. The Corporation may want to consult with its accountants about this.

<sup>61</sup> This sentence has been added in response to the Delaware Chancery Court’s opinion in *SV Investment Partners, LLC v. Thoughtworks, Inc.*, Case No. C.A. 2724 (Del. Ch. Ct. 11/10/10) (see footnote 64), and is intended to require the corporation to use all of its assets (other than those required to pay its debts as they come due and to continue as a going concern under applicable Delaware law) to redeem the Series A Preferred Stock.

<sup>62</sup> Fair market value could also be determined by the Board with the concurrence of the designee of the holders of Series A Preferred Stock on the Board.

<sup>63</sup> The bracketed language, although not commonplace, may be desirable to minority investors in the Series A Preferred. If this is included, also include the applicable bracketed language in Section 6.2.

<sup>64</sup> Investors may also seek enforcement provisions for failure to redeem, including provisions that may entitle the investors to gain control of the Board of Directors. Such provisions are generally atypical in early stage venture transactions but are seen from time to time in private equity and late stage venture transactions. However, that may change in the wake of the Delaware Chancery Court’s opinion in *SV Investment Partners, LLC v. Thoughtworks, Inc.*, Case No. C.A. 2724 (Del. Ch. Ct. 11/10/10) in which the Court construed the words “funds legally available” in a manner unhelpful to investors. The Court described a number of “additional protections” that the investors could have included to give their redemption rights more teeth, and stated that “sophisticated investors understand that mandatory redemption rights provide limited protection and function imperfectly, particularly when a corporation is struggling financially.”

- (a) the number of shares of Series A Preferred Stock held by the holder that the Corporation shall redeem on the Redemption Date specified in the Redemption Notice;
- (b) the Redemption Date and the Redemption Price;
- (c) the date upon which the holder's right to convert such shares terminates (as determined in accordance with Subsection 4.1); and
- (d) that the holder is to surrender to the Corporation, in the manner and at the place designated, his, her or its certificate or certificates representing the shares of Series A Preferred Stock to be redeemed.

[If the Corporation receives, on or prior to the 20th day after the date of delivery of the Redemption Notice to a holder of Series A Preferred Stock, written notice from such holder that such holder elects to be excluded from the redemption provided in this Section 6, then the shares of Series A Preferred Stock registered on the books of the Corporation in the name of such holder at the time of the Corporation's receipt of such notice shall thereafter be "**Excluded Shares.**" Excluded Shares shall not be redeemed or redeemable pursuant to this Section 6, whether on such Redemption Date or thereafter.]

6.3 Surrender of Certificates; Payment. On or before the applicable Redemption Date, each holder of shares of Series A Preferred Stock to be redeemed on such Redemption Date, unless such holder has exercised his, her or its right to convert such shares as provided in Section 4, shall surrender the certificate or certificates representing such shares (or, if such registered holder alleges that such certificate has been lost, stolen or destroyed, a lost certificate affidavit and agreement reasonably acceptable to the Corporation to indemnify the Corporation against any claim that may be made against the Corporation on account of the alleged loss, theft or destruction of such certificate) to the Corporation, in the manner and at the place designated in the Redemption Notice, and thereupon the Redemption Price for such shares shall be payable to the order of the person whose name appears on such certificate or certificates as the owner thereof. In the event less than all of the shares of Series A Preferred Stock represented by a certificate are redeemed, a new certificate representing the unredeemed shares of Series A Preferred Stock shall promptly be issued to such holder.

6.4 Rights Subsequent to Redemption. If the Redemption Notice shall have been duly given, and if on the applicable Redemption Date the Redemption Price payable upon redemption of the shares of Series A Preferred Stock to be redeemed on such Redemption Date is paid or tendered for payment or deposited with an independent payment agent so as to be available therefor in a timely manner, then notwithstanding that the certificates evidencing any of the shares of Series A Preferred Stock so called for redemption shall not have been surrendered, dividends with respect to such shares of Series A Preferred Stock shall cease to accrue after such Redemption Date and all rights with respect to such shares shall forthwith after the Redemption Date terminate, except only the right of the holders to receive the Redemption Price without interest upon surrender of their certificate or certificates therefor.

7. Redeemed or Otherwise Acquired Shares. Any shares of Series A Preferred Stock that are redeemed or otherwise acquired by the Corporation or any of its subsidiaries shall be automatically and immediately cancelled and retired and shall not be



reissued, sold or transferred. Neither the Corporation nor any of its subsidiaries may exercise any voting or other rights granted to the holders of Series A Preferred Stock following redemption.

1. Waiver. Any of the rights, powers, preferences and other terms of the Series A Preferred Stock set forth herein may be waived on behalf of all holders of Series A Preferred Stock by the affirmative written consent or vote of the holders of at least [*specify percentage*] of the shares of Series A Preferred Stock then outstanding.<sup>65</sup>

8. Notices. Any notice required or permitted by the provisions of this Article Fourth to be given to a holder of shares of Series A Preferred Stock shall be mailed, postage prepaid, to the post office address last shown on the records of the Corporation, or given by electronic communication in compliance with the provisions of the General Corporation Law, and shall be deemed sent upon such mailing or electronic transmission.

**FIFTH:** Subject to any additional vote required by the Certificate of Incorporation or Bylaws, in furtherance and not in limitation of the powers conferred by statute, the Board of Directors is expressly authorized to make, repeal, alter, amend and rescind any or all of the Bylaws of the Corporation.

**SIXTH:** Subject to any additional vote required by the Certificate of Incorporation, the number of directors of the Corporation shall be determined in the manner set forth in the Bylaws of the Corporation.

**SEVENTH:** Elections of directors need not be by written ballot unless the Bylaws of the Corporation shall so provide.

**EIGHTH:** Meetings of stockholders may be held within or without the State of Delaware, as the Bylaws of the Corporation may provide. The books of the Corporation may be kept outside the State of Delaware at such place or places as may be designated from time to time by the Board of Directors or in the Bylaws of the Corporation.

**NINTH:** To the fullest extent permitted by law, a director of the Corporation shall not be personally liable to the Corporation or its stockholders for monetary damages for breach of fiduciary duty as a director. If the General Corporation Law or any other law of the State of Delaware is amended after approval by the stockholders of this Article Ninth to authorize corporate action further eliminating or limiting the personal liability of directors, then the liability of a director of the Corporation shall be eliminated or limited to the fullest extent permitted by the General Corporation Law as so amended.

Any repeal or modification of the foregoing provisions of this Article Ninth by the stockholders of the Corporation shall not adversely affect any right or protection of a director of the Corporation existing at the time of, or increase the liability of any director of the Corporation with respect to any acts or omissions of such director occurring prior to, such repeal or modification.

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<sup>65</sup> The percentage of shares of Series A Preferred Stock required for a waiver is generally fixed at the percentage (typically set forth in Subsection 3.3) required to amend the Series A Preferred Stock terms.

**TENTH:** <sup>66</sup> To the fullest extent permitted by applicable law, the Corporation is authorized to provide indemnification of (and advancement of expenses to) directors, officers and agents of the Corporation (and any other persons to which General Corporation Law permits the Corporation to provide indemnification) through Bylaw provisions, agreements with such agents or other persons, vote of stockholders or disinterested directors or otherwise, in excess of the indemnification and advancement otherwise permitted by Section 145 of the General Corporation Law.

Any amendment, repeal or modification of the foregoing provisions of this Article Tenth shall not adversely affect any right or protection of any director, officer or other agent of the Corporation existing at the time of such amendment, repeal or modification.

**ELEVENTH:** [The Corporation renounces, to the fullest extent permitted by law, any interest or expectancy of the Corporation in, or in being offered an opportunity to participate in, any Excluded Opportunity. An “**Excluded Opportunity**” is any matter, transaction or interest that is presented to, or acquired, created or developed by, or which otherwise comes into the possession of, (i) any director of the Corporation who is not an employee of the Corporation or any of its subsidiaries, or (ii) any holder of Series A Preferred Stock or any partner, member, director, stockholder, employee or agent of any such holder, other than someone who is an employee of the Corporation or any of its subsidiaries (collectively, “**Covered Persons**”), unless such matter, transaction or interest is presented to, or acquired, created or developed by, or otherwise comes into the possession of, a Covered Person expressly and solely in such Covered Person’s capacity as a director of the Corporation.]<sup>67</sup>

**TWELFTH:** [Unless the Corporation consents in writing to the selection of an alternative forum, the Court of Chancery in the State of Delaware shall be the sole and exclusive forum for any stockholder (including a beneficial owner) to bring (i) any derivative action or proceeding brought on behalf of the Corporation, (ii) any action asserting a claim of breach of fiduciary duty owed by any director, officer or other employee of the Corporation to the Corporation or the Corporation’s stockholders, (iii) any action asserting a claim against the Corporation, its directors, officers or employees arising pursuant to any provision of the Delaware General Corporation Law or the Corporation’s certificate of incorporation or bylaws or (iv) any action asserting a claim against the Corporation, its directors, officers or employees governed by the internal affairs doctrine, except for, as to each of (i) through (iv) above, any claim as to which the Court of Chancery determines that there is an indispensable party not

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<sup>66</sup> This provision authorizes the indemnification of directors, officers and agents of the Corporation, but does not require it. Investors who have the right or ability to appoint affiliates to the Board of Directors often request that more detailed, mandatory indemnification provisions be included in the Certificate of Incorporation or Bylaws, and/or indemnification contracts and insurance coverage. A form of mandatory indemnification provision, which could be inserted in this Article Tenth in place of what is currently there, is attached as Exhibit A hereto.

<sup>67</sup> Section 122(17) of the DGCL permits the Corporation to renounce in its certificate of incorporation the Corporation’s interest or expectancy in specified business opportunities or specified classes or categories of business opportunities. This enables the Corporation to determine in advance whether these opportunities are corporate opportunities of the Corporation rather than to address such opportunities as they arise. Venture capital investors may be concerned about having to provide these opportunities to the Corporation and thus may seek this type of provision. Note that the defined term “Excluded Opportunity” in the above example is very pro-investor. The foregoing Article Eleventh is merely an example of such a provision, and is not necessarily an appropriate starting point for any particular transaction.

subject to the jurisdiction of the Court of Chancery (and the indispensable party does not consent to the personal jurisdiction of the Court of Chancery within ten days following such determination), which is vested in the exclusive jurisdiction of a court or forum other than the Court of Chancery, or for which the Court of Chancery does not have subject matter jurisdiction. If any provision or provisions of this Article TWELFTH shall be held to be invalid, illegal or unenforceable as applied to any person or entity or circumstance for any reason whatsoever, then, to the fullest extent permitted by law, the validity, legality and enforceability of such provisions in any other circumstance and of the remaining provisions of this Article TWELFTH (including, without limitation, each portion of any sentence of this Article TWELFTH containing any such provision held to be invalid, illegal or unenforceable that is not itself held to be invalid, illegal or unenforceable) and the application of such provision to other persons or entities and circumstances shall not in any way be affected or impaired thereby.]<sup>68</sup>

**THIRTEENTH:** [For purposes of Section 500 of the California Corporations Code (to the extent applicable), in connection with any repurchase of shares of Common Stock permitted under this Certificate of Incorporation from employees, officers, directors or consultants of the Company in connection with a termination of employment or services pursuant to agreements or arrangements approved by the Board of Directors (in addition to any other consent required under this Certificate of Incorporation), such repurchase may be made without regard to any “preferential dividends arrears amount” or “preferential rights amount” (as those terms are defined in Section 500 of the California Corporations Code). Accordingly, for purposes of making any calculation under California Corporations Code Section 500 in connection with such repurchase, the amount of any “preferential dividends arrears amount” or “preferential rights amount” (as those terms are defined therein) shall be deemed to be zero.]<sup>69</sup>

\* \* \*

**3.** That the foregoing amendment and restatement was approved by the holders of the requisite number of shares of this corporation in accordance with Section 228 of the General Corporation Law.

**4.** That this Amended and Restated Certificate of Incorporation, which restates and integrates and further amends the provisions of this Corporation’s Certificate of

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<sup>68</sup> In order to avoid forum shopping in a situation where several courts might have personal and subject matter jurisdiction over the parties and claims, the parties may wish to pick a particular court for any stockholder litigation. The advantage of Delaware is a neutral forum with judges who will be familiar with the issues raised. It may also serve as a disincentive to potential plaintiffs if they have to come to Delaware to litigate. Whether other state courts will honor such a provision and bounce a plaintiff who tries to bring suit elsewhere is at the moment an open question.

<sup>69</sup> Because Section 2115 of the California Corporations Code purports to impose California corporate laws on foreign corporations with sufficient assets and stockholders in the State of California, corporations incorporated in other states with California stockholders and assets in California should consider adopting a provision similar to the one above. Section 500(a) of the California Corporations Code sets forth a solvency test governing when a corporation may make distributions to stockholders or redeem shares of stock, including distributions to junior stockholders and redemptions of junior stock. Section 502(b) of the California Corporations Code allows the corporation and the holders of Preferred Stock to opt out of the restrictions on distributions to junior stockholders and redemptions of junior stock in the Certificate of Incorporation.

Incorporation, has been duly adopted in accordance with Sections 242 and 245 of the General Corporation Law.

**IN WITNESS WHEREOF**, this Amended and Restated Certificate of Incorporation has been executed by a duly authorized officer of this corporation on this [\_\_ day of \_\_\_\_\_, 20\_\_].<sup>70</sup>

By: \_\_\_\_\_  
President

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<sup>70</sup> See DGCL Section 103 for the requirements regarding the execution of the Restated Certificate of Incorporation.

## EXHIBIT A<sup>71</sup>

(Alternative Indemnification Provisions)

**TENTH:** The following indemnification provisions shall apply to the persons enumerated below.

1. Right to Indemnification of Directors and Officers. The Corporation shall indemnify and hold harmless, to the fullest extent permitted by applicable law as it presently exists or may hereafter be amended, any person (an “**Indemnified Person**”) who was or is made or is threatened to be made a party or is otherwise involved in any action, suit or proceeding, whether civil, criminal, administrative or investigative (a “**Proceeding**”), by reason of the fact that such person, or a person for whom such person is the legal representative, is or was a director or officer of the Corporation or, while a director or officer of the Corporation, is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation or of a partnership, joint venture, limited liability company, trust, enterprise or nonprofit entity, including service with respect to employee benefit plans, against all liability and loss suffered and expenses (including attorneys’ fees) reasonably incurred by such Indemnified Person in such Proceeding. Notwithstanding the preceding sentence, except as otherwise provided in Section 3 of this Article Tenth, the Corporation shall be required to indemnify an Indemnified Person in connection with a Proceeding (or part thereof) commenced by such Indemnified Person only if the commencement of such Proceeding (or part thereof) by the Indemnified Person was authorized in advance by the Board of Directors.

2. Prepayment of Expenses of Directors and Officers. The Corporation shall pay the expenses (including attorneys’ fees) incurred by an Indemnified Person in defending any Proceeding in advance of its final disposition, provided, however, that, to the extent required by law, such payment of expenses in advance of the final disposition of the Proceeding shall be made only upon receipt of an undertaking by the Indemnified Person to repay all amounts advanced if it should be ultimately determined that the Indemnified Person is not entitled to be indemnified under this Article Tenth or otherwise.

3. Claims by Directors and Officers. If a claim for indemnification or advancement of expenses under this Article Tenth is not paid in full within 30 days after a written claim therefor by the Indemnified Person has been received by the Corporation, the Indemnified Person may file suit to recover the unpaid amount of such claim and, if successful in whole or in part, shall be entitled to be paid the expense of prosecuting such claim. In any such action the Corporation shall have the burden of proving that the Indemnified Person is not entitled to the requested indemnification or advancement of expenses under applicable law.

4. Indemnification of Employees and Agents. The Corporation may indemnify and advance expenses to any person who was or is made or is threatened to be made or is otherwise

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<sup>71</sup> If indemnification agreements will be used for directors, care should be given to ensure that the provisions of such indemnification agreements and any mandatory indemnification provision contained in the Certificate of Incorporation or Bylaws (or elsewhere) do not conflict.

involved in any Proceeding by reason of the fact that such person, or a person for whom such person is the legal representative, is or was an employee or agent of the Corporation or, while an employee or agent of the Corporation, is or was serving at the request of the Corporation as a director, officer, employee or agent of another corporation or of a partnership, joint venture, limited liability company, trust, enterprise or nonprofit entity, including service with respect to employee benefit plans, against all liability and loss suffered and expenses (including attorney's fees) reasonably incurred by such person in connection with such Proceeding. The ultimate determination of entitlement to indemnification of persons who are non-director or officer employees or agents shall be made in such manner as is determined by the Board of Directors in its sole discretion. Notwithstanding the foregoing sentence, the Corporation shall not be required to indemnify a person in connection with a Proceeding initiated by such person if the Proceeding was not authorized in advance by the Board of Directors.

5. Advancement of Expenses of Employees and Agents. The Corporation may pay the expenses (including attorney's fees) incurred by an employee or agent in defending any Proceeding in advance of its final disposition on such terms and conditions as may be determined by the Board of Directors.

6. Non-Exclusivity of Rights. The rights conferred on any person by this Article Tenth shall not be exclusive of any other rights which such person may have or hereafter acquire under any statute, provision of the certificate of incorporation, these by-laws, agreement, vote of stockholders or disinterested directors or otherwise.

7. Other Indemnification. The Corporation's obligation, if any, to indemnify any person who was or is serving at its request as a director, officer or employee of another Corporation, partnership, limited liability company, joint venture, trust, organization or other enterprise shall be reduced by any amount such person may collect as indemnification from such other Corporation, partnership, limited liability company, joint venture, trust, organization or other enterprise.

8. Insurance. The Board of Directors may, to the full extent permitted by applicable law as it presently exists, or may hereafter be amended from time to time, authorize an appropriate officer or officers to purchase and maintain at the Corporation's expense insurance: (a) to indemnify the Corporation for any obligation which it incurs as a result of the indemnification of directors, officers and employees under the provisions of this Article Tenth; and (b) to indemnify or insure directors, officers and employees against liability in instances in which they may not otherwise be indemnified by the Corporation under the provisions of this Article Tenth.

9. Amendment or Repeal. Any repeal or modification of the foregoing provisions of this Article Tenth shall not adversely affect any right or protection hereunder of any person in respect of any act or omission occurring prior to the time of such repeal or modification. The rights provided hereunder shall inure to the benefit of any Indemnified Person and such person's heirs, executors and administrators.

**This sample document is the work product of a national coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample document presents an array of (often mutually exclusive) options with respect to particular deal provisions.**

**[AMENDED AND RESTATED]  
INVESTORS' RIGHTS AGREEMENT**

### ***Preliminary Notes***

*An Investors' Rights Agreement can cover many different subjects. The most frequent are information rights, registration rights, contractual "rights of first offer" or "preemptive" rights (i.e., the right to purchase securities in subsequent equity financings conducted by the Company), and various post-closing covenants of the Company.*



## TABLE OF CONTENTS

*Note to Drafter: Section headings have been formatted to automatically populate the Table of Contents. However, when editing this document for your own use, the page numbers may change. In order to reflect the correct page numbers in the Table of Contents, you must “update page numbers” to the Table of Contents by (1) right-clicking anywhere in the Table of Contents and (2) choose “update field,” then “update page numbers only.” If you add or delete section headings, follow step (1) and (2) above and choose “update entire table.”*

	<u>Page</u>
1. Definitions.....	2
2. Registration Rights.....	6
2.1 Demand Registration .....	6
2.2 Company Registration .....	8
2.3 Underwriting Requirements.....	9
2.4 Obligations of the Company .....	10
2.5 Furnish Information .....	12
2.6 Expenses of Registration.....	12
2.7 Delay of Registration .....	13
2.8 Indemnification .....	13
2.9 Reports Under Exchange Act.....	15
2.10 Limitations on Subsequent Registration Rights.....	16
2.11 “Market Stand-off” Agreement.....	16
2.12 Restrictions on Transfer .....	18
2.13 Termination of Registration Rights .....	19
3. Information and Observer Rights.....	20
3.1 Delivery of Financial Statements.....	20
3.2 Inspection .....	22
3.3 [Observer Rights .....	22
3.4 Termination of Information [and Observer Rights].....	23
3.5 Confidentiality .....	23
4. Rights to Future Stock Issuances .....	23
4.1 Right of First Offer .....	23
4.2 [Directed IPO Shares .....	26
4.3 Termination.....	26
5. Additional Covenants.....	27
5.1 Insurance .....	27
5.2 Employee Agreements .....	27
5.3 Employee Stock .....	27
5.4 [Qualified Small Business Stock .....	28
5.5 Matters Requiring Investor Director Approval.....	28
5.6 Board Matters.....	29

5.7	Successor Indemnification .....	30
5.8	[Expenses of Counsel.....	30
5.9	[Indemnification Matters .....	30
5.10	Termination of Covenants.....	31
6.	Miscellaneous .....	31
6.1	Successors and Assigns.....	31
6.2	Governing Law .....	32
6.3	Counterparts.....	32
6.4	Titles and Subtitles.....	32
6.5	Notices .....	32
6.6	Amendments and Waivers .....	33
6.7	Severability .....	33
6.8	Aggregation of Stock .....	33
6.9	Additional Investors.....	34
6.10	Entire Agreement.....	34
6.11	Dispute Resolution.....	34
6.12	Delays or Omissions .....	35
6.13	[Acknowledgment.....	36
Schedule A	- Schedule of Investors	
[Schedule B	- Schedule of Key Holders]	
[Exhibit A	- Form of Noncompetition and Nonsolicitation Agreement]	

**[AMENDED AND RESTATED]  
INVESTORS' RIGHTS AGREEMENT**

THIS [AMENDED AND RESTATED] INVESTORS' RIGHTS AGREEMENT is made as of the [ ] day of [\_\_\_\_\_, 20\_\_], by and among [\_\_\_\_], a [Delaware] corporation (the "**Company**"), [and] each of the investors listed on Schedule A hereto, each of which is referred to in this Agreement as an "**Investor**"[,]" and each of the stockholders listed on Schedule B hereto, each of whom is referred to herein as a "**Key Holder**" [and any Additional Purchaser (as defined in the Purchase Agreement) that becomes a party to this Agreement in accordance with Section 6.9 hereof].

**RECITALS**

*[Alternative 1:<sup>1</sup>*

**WHEREAS**, the Company and the Investors are parties to the Series A Preferred Stock Purchase Agreement of even date herewith (the "**Purchase Agreement**"); and

**WHEREAS**, in order to induce the Company to enter into the Purchase Agreement and to induce the Investors to invest funds in the Company pursuant to the Purchase Agreement, the Investors and the Company hereby agree that this Agreement shall govern the rights of the Investors to cause the Company to register shares of Common Stock issuable to the Investors, to receive certain information from the Company, and to participate in future equity offerings by the Company, and shall govern certain other matters as set forth in this Agreement;

**NOW, THEREFORE**, the parties hereby agree as follows:]

*[Alternative 2:<sup>2</sup>*

**WHEREAS**, certain of the Investors (the "**Existing Investors**") hold shares of the Company's Series [ ] Preferred Stock and/or shares of Common Stock issued upon conversion thereof and possess registration rights, information rights, rights of first offer, and other rights pursuant to an Investors' Rights Agreement dated as of [\_\_\_\_\_, 20\_\_] between the Company and such Investors (the "**Prior Agreement**"); and

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<sup>1</sup> This first set of Recitals is appropriate when you are drafting legal documents in connection with the Company's sale of its first series of preferred stock (Series A). Consider adding references to Key Holders in the Recitals, as appropriate.

<sup>2</sup> This second set of Recitals assumes that a preexisting Investors' Rights Agreement is being superseded and replaced with a new version. It contemplates two different series of preferred stock (Series A and B). Appropriate modifications to this form will be required based on the actual series of preferred stock outstanding and the respective rights of such series. This Agreement contemplates the amendment and restatement of the Prior Agreement so that the parties to the existing agreement become parties to this Agreement regardless of whether they execute this Agreement; alternatively, the existing agreement could be terminated and all existing investors would be required to execute this Agreement. See also Section-6.10. Consider adding references to Key Holders in the Recitals, as appropriate.

**WHEREAS**, the Existing Investors are holders of at least [\_\_\_\_\_] percent (\_\_\_%) of the Registrable Securities of the Company (as defined in the Prior Agreement), and desire to [amend and restate] [terminate] the Prior Agreement in its entirety and to accept the rights created pursuant to this Agreement in lieu of the rights granted to them under the Prior Agreement; and

**WHEREAS**, certain of the Investors are parties to that certain Series [ ] Preferred Stock Purchase Agreement of even date herewith between the Company and certain of the Investors (the “**Purchase Agreement**”), under which certain of the Company’s and such Investors’ obligations are conditioned upon the execution and delivery of this Agreement by such Investors, Existing Investors holding at least [\_\_\_\_\_] percent (\_\_\_%) of the Registrable Securities, and the Company;

**NOW, THEREFORE**, the Existing Investors hereby agree that the Prior Agreement shall be [amended and restated] [superseded and replaced in its entirety by this Agreement], and the parties to this Agreement further agree as follows:]

1. Definitions. For purposes of this Agreement:

1.1 “**Affiliate**” means, with respect to any specified Person, any other Person who, directly or indirectly, controls, is controlled by, or is under common control with such Person, including without limitation any general partner, managing member, officer or director of such Person or any venture capital fund now or hereafter existing that is controlled by one or more general partners or managing members of, or shares the same management company with, such Person.

1.2 “**Common Stock**” means shares of the Company’s common stock, par value [\$0.\_\_\_\_] per share.

1.3 [“**Competitor**” means a **Person engaged, directly or indirectly (including through any partnership, limited liability company, corporation, joint venture or similar arrangement (whether now existing or formed hereafter)), in [description of business], but shall not include any financial investment firm or collective investment vehicle that, together with its Affiliates, holds less than [20]% of the outstanding equity of any Competitor and does not, nor do any of its Affiliates, have a right to designate any members of the Board of Directors of any Competitor.**]

1.4 “**Damages**” means any loss, damage, claim or liability (joint or several) to which a party hereto may become subject under the Securities Act, the Exchange Act, or other federal or state law, insofar as such loss, damage, claim or liability (or any action in respect thereof) arises out of or is based upon (i) any untrue statement or alleged untrue statement of a material fact contained in any registration statement of the Company, including any preliminary prospectus or final prospectus contained therein or any amendments or supplements thereto; (ii) an omission or alleged omission to state therein a material fact required to be stated therein, or necessary to make the statements therein not misleading; or (iii) any violation or alleged violation by the indemnifying party (or any of its agents or Affiliates) of the Securities Act, the

Exchange Act, any state securities law, or any rule or regulation promulgated under the Securities Act, the Exchange Act, or any state securities law.

1.5 “**Derivative Securities**” means any securities or rights convertible into, or exercisable or exchangeable for (in each case, directly or indirectly), Common Stock, including options and warrants.

1.6 “**Exchange Act**” means the Securities Exchange Act of 1934, as amended, and the rules and regulations promulgated thereunder.

1.7 “**Excluded Registration**” means (i) a registration relating to the sale of securities to employees of the Company or a subsidiary pursuant to a stock option, stock purchase, or similar plan; (ii) a registration relating to an SEC Rule 145 transaction; (iii) a registration on any form that does not include substantially the same information as would be required to be included in a registration statement covering the sale of the Registrable Securities; or (iv) a registration in which the only Common Stock being registered is Common Stock issuable upon conversion of debt securities that are also being registered.

1.8 [“**FOIA Party**” means a Person that, in the [reasonable] determination of the Board of Directors, may be subject to, and thereby required to disclose non-public information furnished by or relating to the Company under, the Freedom of Information Act, 5 U.S.C. 552 (“**FOIA**”), any state public records access law, any state or other jurisdiction’s laws similar in intent or effect to FOIA, or any other similar statutory or regulatory requirement.]

1.9 “**Form S-1**” means such form under the Securities Act as in effect on the date hereof or any successor registration form under the Securities Act subsequently adopted by the SEC.

1.10 “**Form S-3**” means such form under the Securities Act as in effect on the date hereof or any registration form under the Securities Act subsequently adopted by the SEC that permits incorporation of substantial information by reference to other documents filed by the Company with the SEC.

1.11 “**GAAP**” means generally accepted accounting principles in the United States.

1.12 “**Holder**” means any holder of Registrable Securities who is a party to this Agreement.

1.13 “**Immediate Family Member**” means a child, stepchild, grandchild, parent, stepparent, grandparent, spouse, sibling, mother-in-law, father-in-law, son-in-law, daughter-in-law, brother-in-law, or sister-in-law, including adoptive relationships, of a natural person referred to herein.<sup>3</sup>

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<sup>3</sup> Consider whether members of the same household, *e.g.*, life partners or others covered under the applicable domestic relations statute, should be included in the definition.

1.14 “**Initiating Holders**” means, collectively, Holders who properly initiate a registration request under this Agreement.

1.15 “**IPO**” means the Company’s first underwritten public offering of its Common Stock under the Securities Act.

1.16 “**Key Employee**” means any executive-level employee (including division director and vice president-level positions) as well as any employee who, either alone or in concert with others, develops, invents, programs, or designs any Company Intellectual Property (as defined in the Purchase Agreement).<sup>4</sup>

1.17 [“**Key Holder Registrable Securities**” means (i) the [\_\_\_\_\_] shares of Common Stock held by the Key Holders, and (ii) any Common Stock issued as (or issuable upon the conversion or exercise of any warrant, right, or other security that is issued as) a dividend or other distribution with respect to, or in exchange for or in replacement of such shares.]

1.18 “**Major Investor**” means any Investor that, individually or together with such Investor’s Affiliates, holds at least [\_\_\_\_\_] shares of Registrable Securities (as adjusted for any stock split, stock dividend, combination, or other recapitalization or reclassification effected after the date hereof).

1.19 “**New Securities**” means, collectively, equity securities of the Company, whether or not currently authorized, as well as rights, options, or warrants to purchase such equity securities, or securities of any type whatsoever that are, or may become, convertible or exchangeable into or exercisable for such equity securities.

1.20 “**Person**” means any individual, corporation, partnership, trust, limited liability company, association or other entity.

1.21 [“**Preferred Stock**” means, collectively, shares of the Company’s Series A Preferred Stock and Series [\_] Preferred Stock.]<sup>5</sup>

1.22 “**Registrable Securities**” means (i) the Common Stock issuable or issued upon conversion of the [Series A] Preferred Stock[, excluding any Common Stock issued upon conversion of the [Series A] Preferred Stock pursuant to the “Special Mandatory Conversion” provisions of the Company’s Certificate of Incorporation<sup>6</sup>]; [(ii) any Common Stock, or any Common Stock issued or issuable (directly or indirectly) upon conversion and/or exercise of any other securities of the Company, acquired by the Investors after the date hereof]; [(iii) the Key

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<sup>4</sup> In a Series A round at a high-tech start-up, it is likely that the only key employees in addition to management, if any, are those who are responsible for developing the Company’s key intellectual property assets. It may be simpler for these early-stage companies to list the Key Employees by name. In later rounds, it may be appropriate to include others, e.g., important salespeople or consultants and define Key Employees by function (e.g., division director).

<sup>5</sup> Note that this definition is unnecessary unless there are multiple series of preferred stock.

<sup>6</sup> If the Company’s Certificate of Incorporation contains a “pay-to-play” provision, consider whether shares issued upon a “Special Mandatory Conversion” pursuant thereto should lose their status as Registrable Securities. See Section 5A of Part C of Article Fourth of the Model Certificate of Incorporation.

Holder Registrable Securities,<sup>7</sup> provided, however, that such Key Holder Registrable Securities shall not be deemed Registrable Securities and the Key Holders shall not be deemed Holders for the purposes of Subsections 2.1, 2.10, [3.1, 3.2, 4.1 and 6.6;] and [(iv)] any Common Stock issued as (or issuable upon the conversion or exercise of any warrant, right, or other security that is issued as) a dividend or other distribution with respect to, or in exchange for or in replacement of, the shares referenced in clause[s] (i) [and (ii)] above; excluding in all cases, however, any Registrable Securities sold by a Person in a transaction in which the applicable rights under this Agreement are not assigned pursuant to Subsection 6.1, and excluding for purposes of Section 2 any shares for which registration rights have terminated pursuant to Subsection 2.13 of this Agreement.<sup>8</sup>

1.23 “**Registrable Securities then outstanding**” means the number of shares determined by adding the number of shares of outstanding Common Stock that are Registrable Securities and the number of shares of Common Stock issuable (directly or indirectly) pursuant to then exercisable and/or convertible securities that are Registrable Securities.

1.24 “**Restricted Securities**” means the securities of the Company required to bear the legend set forth in Subsection 2.12(b) hereof.

1.25 “**SEC**” means the Securities and Exchange Commission.

1.26 “**SEC Rule 144**” means Rule 144 promulgated by the SEC under the Securities Act.

1.27 “**SEC Rule 145**” means Rule 145 promulgated by the SEC under the Securities Act.

1.28 “**Securities Act**” means the Securities Act of 1933, as amended, and the rules and regulations promulgated thereunder.

1.29 “**Selling Expenses**” means all underwriting discounts, selling commissions, and stock transfer taxes applicable to the sale of Registrable Securities, and fees and disbursements of counsel for any Holder, except for the fees and disbursements of the Selling Holder Counsel borne and paid by the Company as provided in Subsection 2.6.

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<sup>7</sup> Typically, Key Holders of common stock are not granted registration rights. In certain instances it may be appropriate to grant Key Holders (e.g., founders, significant early-round angel investors) piggyback and/or S-3 registration rights, although often they will be subordinate to investors on underwriter cutbacks. If such rights are granted, provision must be made throughout this form to include such rights and provide for appropriate cutbacks and limitations and protection in the event of amendments and waivers.

<sup>8</sup> Registrable Securities are defined in terms of common stock because preferred stock of venture-capital-backed companies is usually not sold or marketed at an IPO. The language “issued or issuable” should be present so that the definition works regardless of whether or not the preferred stock has yet been converted. Note that the effect of the transferability section is such that certain sizeable transfers of shares pursuant to available exemptions under the Securities Act will not remove the registration rights associated with those shares.

1.30 “**Series A Director**” means any director of the Company that the holders of record of the Series A Preferred Stock are entitled to elect pursuant to the Company’s Certificate of Incorporation.

1.31 “**Series A Preferred Stock**” means shares of the Company’s Series A Preferred Stock, par value [\$0.\_\_\_\_] per share.

2. Registration Rights. The Company covenants and agrees as follows:

2.1 Demand Registration.

(a) Form S-1 Demand. If at any time after [the earlier of (i) [three (3)-five (5) years] after the date of this Agreement or (ii)] [one hundred eighty (180)] days<sup>9</sup> after the effective date of the registration statement for the IPO, the Company receives a request from Holders of [\_\_\_\_ percent (\_\_\_\_%)]<sup>10</sup> of the Registrable Securities then outstanding that the Company file a Form S-1 registration statement with respect to [at least forty percent (40%)]<sup>11</sup> of the Registrable Securities then outstanding [(or a lesser percent if the anticipated aggregate offering price, net of Selling Expenses, would exceed \$[5-15] million)], then the Company shall (x) within ten (10) days after the date such request is given, give notice thereof (the “**Demand Notice**”) to all Holders other than the Initiating Holders; and (y) as soon as practicable, and in any event within sixty (60) days after the date such request is given by the Initiating Holders, file a Form S-1 registration statement under the Securities Act covering all Registrable Securities that the Initiating Holders requested to be registered and any additional Registrable Securities requested to be included in such registration by any other Holders, as specified by notice given by each such Holder to the Company within [twenty (20)] days of the date the Demand Notice is given, and in each case, subject to the limitations of Subsection 2.1(c) and Subsection 2.3.

(b) Form S-3 Demand. If at any time when it is eligible to use a Form S-3 registration statement, the Company receives a request from Holders of at least [ten-thirty] percent ([10-30]%) of the Registrable Securities then outstanding that the Company file a Form

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<sup>9</sup> The starting time period for initiating registration rights usually has these two components. The first time period is designed to allow the investors to force the Company to go public if it has not already done so (three to five years is common for this), although practically speaking this rarely, if ever, happens. The second time period is set around the expiration of any underwriter lockups after an IPO, which usually expire 180 days after the IPO. See Section 2.11.

<sup>10</sup> As with all percentage vote thresholds, consideration will need to be given to whether any single investor can either control or block the vote. When dealing with multiple classes of preferred stock, it is important to understand the composition of the stockholder base to ensure that each series is getting the rights it bargained for. The Company will want this percentage to be high enough so that a significant portion of the investor base is behind the demand to cause the Company to effect a registered offering, particularly an IPO. Companies typically will resist allowing a single minority investor to cause a registration. Experienced investors will want to ensure that less experienced investors do not have the right to cause a demand registration. In some cases, holders of different series of preferred stock may request the right for that series to initiate a certain number of demand registrations. Companies typically will resist this due to the cost and diversion of management resources when multiple constituencies have this right.

<sup>11</sup> A trigger threshold may be negotiated and can range from 20% to 100% of total Registrable Securities for demand registrations. However, some companies do not impose a threshold, relying instead on the minimum offering size.



S-3 registration statement with respect to outstanding Registrable Securities of such Holders having an anticipated aggregate offering price, net of Selling Expenses, of at least \$[1-5] million, then the Company shall (i) within ten (10) days after the date such request is given, give a Demand Notice to all Holders other than the Initiating Holders; and (ii) as soon as practicable, and in any event within [forty-five (45)] days after the date such request is given by the Initiating Holders, file a Form S-3 registration statement under the Securities Act covering all Registrable Securities requested to be included in such registration by any other Holders, as specified by notice given by each such Holder to the Company within [twenty (20)] days of the date the Demand Notice is given, and in each case, subject to the limitations of Subsection 2.1(c) and Subsection 2.3.

(c) Notwithstanding the foregoing obligations, if the Company furnishes to Holders requesting a registration pursuant to this Subsection 2.1 a certificate signed by the Company's chief executive officer stating that in the good faith judgment of the Company's Board of Directors it would be materially detrimental to the Company and its stockholders for such registration statement to either become effective or remain effective for as long as such registration statement otherwise would be required to remain effective, because such action would (i) materially interfere with a significant acquisition, corporate reorganization, or other similar transaction involving the Company; (ii) require premature disclosure of material information that the Company has a bona fide business purpose for preserving as confidential; or (iii) render the Company unable to comply with requirements under the Securities Act or Exchange Act,<sup>12</sup> then the Company shall have the right to defer taking action with respect to such filing[, and any time periods with respect to filing or effectiveness thereof shall be tolled correspondingly,] for a period of not more than [thirty (30) - one hundred twenty (120)] days after the request of the Initiating Holders is given; provided, however, that the Company may not invoke this right more than [once] in any twelve (12) month period<sup>13</sup> [; and provided further that the Company shall not register any securities for its own account or that of any other stockholder during such [thirty (30)-one hundred twenty (120)] day period other than [an Excluded Registration] [*Alternative:* pursuant to a registration relating to the sale of securities to employees of the Company or a subsidiary pursuant to a stock option, stock purchase, or similar plan; a registration on any form that does not include substantially the same information as would be required to be included in a registration statement covering the sale of the Registrable

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<sup>12</sup> This section is designed to give the Company a "blackout" period pursuant to which it can suspend registrations due to the timing of certain other corporate events that could affect its stock. A broader, more pro-Company alternative to listing specific, limited situations in which the Company can suspend registration is to provide more generally: "it would be materially detrimental to the Company and its stockholders for such registration statement to be filed and it is therefore necessary to defer the filing of such registration statement."

<sup>13</sup> It is common to limit use of the blackout provisions to one time in any 12-month period. Some companies seek blackouts twice in 12 months or one time for every registration, but investors generally view this as too restrictive on investors (especially when combined with the delay period for Company registrations and the lockup period). A common formulation is to permit one blackout of up to 120 days in any 12-month period. However, it provides greater flexibility to the Company and may also be better for the investors to provide instead for two 60-day periods in any 12-month period, which the Company can combine if necessary to achieve a total blackout of 120 days.

Securities; or a registration in which the only Common Stock being registered is Common Stock issuable upon conversion of debt securities that are also being registered].<sup>14</sup>

(d) The Company shall not be obligated to effect, or to take any action to effect, any registration pursuant to Subsection 2.1(a)(i) during the period that is [sixty (60)] days before the Company's good faith estimate of the date of filing of, and ending on a date that is [one hundred eighty (180)] days after the effective date of, a Company-initiated registration, provided, that the Company is actively employing in good faith commercially reasonable efforts to cause such registration statement to become effective; (ii) after the Company has effected [one-two] registration[s] pursuant to Subsection 2.1(a); or (iii) if the Initiating Holders propose to dispose of shares of Registrable Securities that may be immediately registered on Form S-3 pursuant to a request made pursuant to Subsection 2.1(b). The Company shall not be obligated to effect, or to take any action to effect, any registration pursuant to Subsection 2.1(b) (i) during the period that is [thirty (30)] days before the Company's good faith estimate of the date of filing of, and ending on a date that is [ninety (90)] days after the effective date of, a Company-initiated registration, provided, that the Company is actively employing in good faith commercially reasonable efforts to cause such registration statement to become effective; or (ii) if the Company has effected [two] registration[s] pursuant to Subsection 2.1(b) within the twelve (12) month period immediately preceding the date of such request. A registration shall not be counted as "effected" for purposes of this Subsection 2.1(d) until such time as the applicable registration statement has been declared effective by the SEC, unless the Initiating Holders withdraw their request for such registration, elect not to pay the registration expenses therefor, and forfeit their right to one demand registration statement pursuant to Subsection 2.6, in which case such withdrawn registration statement shall be counted as "effected" for purposes of this Subsection 2.1(d).

2.2 Company Registration. If the Company proposes to register (including, for this purpose, a registration effected by the Company for stockholders other than the Holders) any of its [Common Stock][securities] under the Securities Act in connection with the public offering of such securities solely for cash (other than in an Excluded Registration), the Company shall, at such time, promptly give each Holder notice of such registration. Upon the request of each Holder given within twenty (20) days after such notice is given by the Company, the Company shall, subject to the provisions of Subsection 2.3, cause to be registered all of the Registrable Securities that each such Holder has requested to be included in such registration. The Company shall have the right to terminate or withdraw any registration initiated by it under this Subsection 2.2 before the effective date of such registration, whether or not any Holder has elected to include Registrable Securities in such registration. The expenses (other than Selling Expenses) of such withdrawn registration shall be borne by the Company in accordance with Subsection 2.6.

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<sup>14</sup> Note that the alternative carve-out provision from the limitation on the Company's right to register securities for its own account during a blackout period does not include a carve-out for a registration relating to a Rule 145 transaction. From the investors' perspective, although it may be acceptable for the Company to delay a resale registration in the circumstances set forth in this provision, those circumstances should not entitle the Company to file, e.g., a Form S-4 for a Rule 145 transaction, in priority to a registration requested by the Holders of Registrable Securities. However, from the Company's perspective, the inability to file the S-4 could be a hindrance to an acquisition.

### 2.3 Underwriting Requirements.

(a) If, pursuant to Subsection 2.1, the Initiating Holders intend to distribute the Registrable Securities covered by their request by means of an underwriting, they shall so advise the Company as a part of their request made pursuant to Subsection 2.1, and the Company shall include such information in the Demand Notice. The underwriter(s) will be selected by the [Company and shall be reasonably acceptable to a majority in interest of the Initiating Holders] [*Alternative*: Initiating Holders, subject only to the reasonable approval of the Company]. In such event, the right of any Holder to include such Holder's Registrable Securities in such registration shall be conditioned upon such Holder's participation in such underwriting and the inclusion of such Holder's Registrable Securities in the underwriting to the extent provided herein. All Holders proposing to distribute their securities through such underwriting shall (together with the Company as provided in Subsection 2.4(e)) enter into an underwriting agreement in customary form with the underwriter(s) selected for such underwriting. Notwithstanding any other provision of this Subsection 2.3, if the [managing] underwriter(s) advise(s) the Initiating Holders in writing that marketing factors require a limitation on the number of shares to be underwritten, then the Initiating Holders shall so advise all Holders of Registrable Securities that otherwise would be underwritten pursuant hereto, and the number of Registrable Securities that may be included in the underwriting shall be allocated among such Holders of Registrable Securities, including the Initiating Holders, in proportion (as nearly as practicable) to the number of Registrable Securities owned by each Holder or in such other proportion as shall mutually be agreed to by all such selling Holders; provided, however, that the number of Registrable Securities held by the Holders to be included in such underwriting shall not be reduced unless all other securities are first entirely excluded from the underwriting. [To facilitate the allocation of shares in accordance with the above provisions, the Company or the underwriters may round the number of shares allocated to any Holder to the nearest 100 shares.]

(b) In connection with any offering involving an underwriting of shares of the Company's capital stock pursuant to Subsection 2.2, the Company shall not be required to include any of the Holders' Registrable Securities in such underwriting unless the Holders accept the terms of the underwriting as agreed upon between the Company and its underwriters, and then only in such quantity as the underwriters in their sole discretion determine will not jeopardize the success of the offering by the Company. If the total number of securities, including Registrable Securities, requested by stockholders to be included in such offering exceeds the number of securities to be sold (other than by the Company) that the underwriters in their reasonable discretion determine is compatible with the success of the offering, then the Company shall be required to include in the offering only that number of such securities, including Registrable Securities, which the underwriters and the Company in their sole discretion determine will not jeopardize the success of the offering. If the underwriters determine that less than all of the Registrable Securities requested to be registered can be included in such offering, then the Registrable Securities that are included in such offering shall be allocated among the selling Holders in proportion (as nearly as practicable to) the number of Registrable Securities owned by each selling Holder or in such other proportions as shall mutually be agreed to by all such selling Holders. [To facilitate the allocation of shares in accordance with the above provisions, the Company or the underwriters may round the number of shares allocated to any Holder to the nearest 100 shares.] Notwithstanding the foregoing, in no event shall (i) the

number of Registrable Securities included in the offering be reduced unless all other securities (other than securities to be sold by the Company) are first entirely excluded from the offering, [or] (ii) the number of Registrable Securities included in the offering be reduced below [twenty-three] percent ([20-30]%) of the total number of securities included in such offering, unless such offering is the IPO, in which case the selling Holders may be excluded further if the underwriters make the determination described above and no other stockholder's securities are included in such offering [or (iii) notwithstanding (ii) above, any Registrable Securities which are not Key Holder Registrable Securities be excluded from such underwriting unless all Key Holder Registrable Securities are first excluded from such offering.]<sup>15</sup> For purposes of the provision in this Subsection 2.3(b) concerning apportionment, for any selling Holder that is a partnership, limited liability company, or corporation, the partners, members, retired partners, retired members, stockholders, and Affiliates of such Holder, or the estates and Immediate Family Members of any such partners, retired partners, members, and retired members and any trusts for the benefit of any of the foregoing Persons, shall be deemed to be a single "selling Holder," and any pro rata reduction with respect to such "selling Holder" shall be based upon the aggregate number of Registrable Securities owned by all Persons included in such "selling Holder," as defined in this sentence.

(c) [For purposes of Subsection 2.1, a registration shall not be counted as "effected" if, as a result of an exercise of the underwriter's cutback provisions in Subsection 2.3(a), fewer than [fifty percent (50%)] of the total number of Registrable Securities that Holders have requested to be included in such registration statement are actually included.]

2.4 Obligations of the Company. Whenever required under this Section 2 to effect the registration of any Registrable Securities, the Company shall, as expeditiously as reasonably possible:<sup>16</sup>

(a) prepare and file with the SEC a registration statement with respect to such Registrable Securities and use its commercially reasonable efforts<sup>17</sup> to cause such registration statement to become effective and, upon the request of the Holders of a majority of the Registrable Securities registered thereunder, keep such registration statement effective for a period of up to one hundred twenty (120) days or, if earlier, until the distribution contemplated in the registration statement has been completed; provided, however, that (i) such one hundred twenty (120) day period shall be extended for a period of time equal to the period the Holder refrains, at the request of an underwriter of Common Stock (or other securities) of the Company,

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<sup>15</sup> This language is commonly referred to as the "underwriter cutback" section. In some offerings, an underwriter may determine it can successfully market only a certain number of securities and must therefore reduce the size of the overall registration. When this happens, the holders of Registrable Securities are generally entitled to include their shares before anybody else (consider whether later series may want priority over earlier series). If there is not enough room for these holders, the cutback should be pro rata based on shares held and not "shares requested to be included" (which only creates a race to request and an incentive to request all amounts held every time). Also, if Key Holders have been given registration rights, consider priority of cutback for such Key Holders.

<sup>16</sup> This section simply lists the undertakings of the Company in the event of a registration. As a practical matter, this language will be superseded by any underwriting agreement as part of an underwritten offering.

<sup>17</sup> Much ink has been spilled addressing the distinctions, or lack thereof, among the "best efforts," "commercially reasonable efforts," "reasonable efforts," and similar performance standards. This Agreement uses "commercially reasonable efforts" as the default performance standard.

from selling any securities included in such registration[, and (ii) in the case of any registration of Registrable Securities on Form S-3 that are intended to be offered on a continuous or delayed basis, subject to compliance with applicable SEC rules, such one hundred twenty (120) day period shall be extended for up to [\_\_\_\_\_] days, if necessary, to keep the registration statement effective until all such Registrable Securities are sold];

(b) prepare and file with the SEC such amendments and supplements to such registration statement, and the prospectus used in connection with such registration statement, as may be necessary to comply with the Securities Act in order to enable the disposition of all securities covered by such registration statement;

(c) furnish to the selling Holders such numbers of copies of a prospectus, including a preliminary prospectus, as required by the Securities Act, and such other documents as the Holders may reasonably request in order to facilitate their disposition of their Registrable Securities;

(d) use its commercially reasonable efforts to register and qualify the securities covered by such registration statement under such other securities or blue-sky laws of such jurisdictions as shall be reasonably requested by the selling Holders; provided that the Company shall not be required to qualify to do business or to file a general consent to service of process in any such states or jurisdictions,<sup>18</sup> unless the Company is already subject to service in such jurisdiction and except as may be required by the Securities Act;

(e) in the event of any underwritten public offering, enter into and perform its obligations under an underwriting agreement, in usual and customary form, with the underwriter(s) of such offering;

(f) use its commercially reasonable efforts to cause all such Registrable Securities covered by such registration statement to be listed on a national securities exchange or trading system and each securities exchange and trading system (if any) on which similar securities issued by the Company are then listed;

(g) provide a transfer agent and registrar for all Registrable Securities registered pursuant to this Agreement and provide a CUSIP number for all such Registrable Securities, in each case not later than the effective date of such registration;

(h) promptly make available for inspection by the selling Holders, any [managing] underwriter(s) participating in any disposition pursuant to such registration statement, and any attorney or accountant or other agent retained by any such underwriter or selected by the selling Holders, all financial and other records, pertinent corporate documents, and properties of the Company, and cause the Company's officers, directors, employees, and independent accountants to supply all information reasonably requested by any such seller, underwriter, attorney, accountant, or agent, in each case, as necessary or advisable to verify the

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<sup>18</sup> This is generally viewed as a burdensome requirement for a Company, so it is often carved out of required registrations.

accuracy of the information in such registration statement and to conduct appropriate due diligence in connection therewith;<sup>19</sup>

(i) notify each selling Holder, promptly after the Company receives notice thereof, of the time when such registration statement has been declared effective or a supplement to any prospectus forming a part of such registration statement has been filed; and

(j) after such registration statement becomes effective, notify each selling Holder of any request by the SEC that the Company amend or supplement such registration statement or prospectus.

In addition, the Company shall ensure that, at all times after any registration statement covering a public offering of securities of the Company under the Securities Act shall have become effective, its insider trading policy shall provide that the Company's directors may implement a trading program under Rule 10b5-1 of the Exchange Act.

2.5 Furnish Information. It shall be a condition precedent to the obligations of the Company to take any action pursuant to this Section 2 with respect to the Registrable Securities of any selling Holder that such Holder shall furnish to the Company such information regarding itself, the Registrable Securities held by it, and the intended method of disposition of such securities as is reasonably required to effect the registration of such Holder's Registrable Securities.

2.6 Expenses of Registration. All expenses (other than Selling Expenses) incurred in connection with registrations, filings, or qualifications pursuant to Section 2, including all registration, filing, and qualification fees; printers' and accounting fees; fees and disbursements of counsel for the Company; and the reasonable fees and disbursements[, not to exceed \$\_\_\_\_,] of one counsel for the selling Holders ("**Selling Holder Counsel**"), shall be borne and paid by the Company; provided, however, that the Company shall not be required to pay for any expenses of any registration proceeding begun pursuant to Subsection 2.1 if the registration request is subsequently withdrawn at the request of the Holders of a majority of the Registrable Securities to be registered (in which case all selling Holders shall bear such expenses pro rata based upon the number of Registrable Securities that were to be included in the withdrawn registration), unless the Holders of a majority of the Registrable Securities agree to forfeit their right to one registration pursuant to Subsection 2.1(a) or Subsection 2.1(b), as the case may be; provided further that if, at the time of such withdrawal, the Holders shall have learned of a material adverse change in the condition, business, or prospects of the Company from that known to the Holders at the time of their request and have withdrawn the request with reasonable promptness after learning of such information] then the Holders shall not be required to pay any of such expenses and shall not forfeit their right to one registration pursuant to Subsection 2.1(a) or Subsection 2.1(b). All Selling Expenses relating to Registrable Securities registered pursuant to this Section 2 shall be borne and paid by the Holders pro rata on the basis of the number of Registrable Securities registered on their behalf.

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<sup>19</sup> This inspection right is necessary to enable the selling Holders and underwriters to undertake their due-diligence investigation in connection with the distribution. In facilitating the due-diligence investigations, the Company must be sensitive to its obligations under Regulation FD under the Securities Act.

2.7 Delay of Registration. No Holder shall have any right to obtain or seek an injunction restraining or otherwise delaying any registration pursuant to this Agreement as the result of any controversy that might arise with respect to the interpretation or implementation of this Section 2.

2.8 Indemnification.<sup>20</sup> If any Registrable Securities are included in a registration statement under this Section 2:

(a) To the extent permitted by law, the Company will indemnify and hold harmless each selling Holder, and the partners, members, officers, directors, and stockholders of each such Holder; legal counsel and accountants for each such Holder; any underwriter (as defined in the Securities Act) for each such Holder; and each Person, if any, who controls such Holder or underwriter within the meaning of the Securities Act or the Exchange Act, against any Damages, and the Company will pay to each such Holder, underwriter, controlling Person, or other aforementioned Person any legal or other expenses reasonably incurred thereby in connection with investigating or defending any claim or proceeding from which Damages may result, as such expenses are incurred; provided, however, that the indemnity agreement contained in this Subsection 2.8(a) shall not apply to amounts paid in settlement of any such claim or proceeding if such settlement is effected without the consent of the Company, which consent shall not be unreasonably withheld, nor shall the Company be liable for any Damages to the extent that they arise out of or are based upon actions or omissions made in reliance upon and in conformity with written information furnished by or on behalf of any such Holder, underwriter, controlling Person, or other aforementioned Person expressly for use in connection with such registration.

(b) To the extent permitted by law, each selling Holder, severally and not jointly, will indemnify and hold harmless the Company, and each of its directors, each of its officers who has signed the registration statement, each Person (if any), who controls the Company within the meaning of the Securities Act, legal counsel and accountants for the Company, any underwriter (as defined in the Securities Act), any other Holder selling securities in such registration statement, and any controlling Person of any such underwriter or other Holder, against any Damages, in each case only to the extent that such Damages arise out of or are based upon actions or omissions made in reliance upon and in conformity with written information furnished by or on behalf of such selling Holder expressly for use in connection with such registration; and each such selling Holder will pay to the Company and each other aforementioned Person any legal or other expenses reasonably incurred thereby in connection with investigating or defending any claim or proceeding from which Damages may result, as such expenses are incurred; provided, however, that the indemnity agreement contained in this Subsection 2.8(b) shall not apply to amounts paid in settlement of any such claim or proceeding if such settlement is effected without the consent of the Holder, which consent shall not be unreasonably withheld; and provided further that in no event shall the aggregate amounts payable by any Holder by way of indemnity or contribution under Subsections 2.8(b) and 2.8(d)

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<sup>20</sup> Note that as a practical matter underwriting agreements also provide for indemnification obligations, and therefore it is important to review the indemnification provisions carefully in connection with underwritten public offerings.

exceed the proceeds from the offering received by such Holder (net of any Selling Expenses paid by such Holder), except in the case of fraud or willful misconduct by such Holder.

(c) Promptly after receipt by an indemnified party under this Subsection 2.8 of notice of the commencement of any action (including any governmental action) for which a party may be entitled to indemnification hereunder, such indemnified party will, if a claim in respect thereof is to be made against any indemnifying party under this Subsection 2.8, give the indemnifying party notice of the commencement thereof. The indemnifying party shall have the right to participate in such action and, to the extent the indemnifying party so desires, participate jointly with any other indemnifying party to which notice has been given, and to assume the defense thereof with counsel mutually satisfactory to the parties; provided, however, that an indemnified party (together with all other indemnified parties that may be represented without conflict by one counsel) shall have the right to retain one separate counsel, with the fees and expenses to be paid by the indemnifying party, if representation of such indemnified party by the counsel retained by the indemnifying party would be inappropriate due to actual or potential differing interests between such indemnified party and any other party represented by such counsel in such action. [The failure to give notice to the indemnifying party within a reasonable time of the commencement of any such action shall relieve such indemnifying party of any liability to the indemnified party under this Subsection 2.8, to the extent that such failure materially prejudices the indemnifying party's ability to defend such action. The failure to give notice to the indemnifying party will not relieve it of any liability that it may have to any indemnified party otherwise than under this Subsection 2.8.]

(d) To provide for just and equitable contribution to joint liability under the Securities Act in any case in which either (i) any party otherwise entitled to indemnification hereunder makes a claim for indemnification pursuant to this Subsection 2.8 but it is judicially determined (by the entry of a final judgment or decree by a court of competent jurisdiction and the expiration of time to appeal or the denial of the last right of appeal) that such indemnification may not be enforced in such case, notwithstanding the fact that this Subsection 2.8 provides for indemnification in such case, or (ii) contribution under the Securities Act may be required on the part of any party hereto for which indemnification is provided under this Subsection 2.8, then, and in each such case, such parties will contribute to the aggregate losses, claims, damages, liabilities, or expenses to which they may be subject (after contribution from others) in such proportion as is appropriate to reflect the relative fault of each of the indemnifying party and the indemnified party in connection with the statements, omissions, or other actions that resulted in such loss, claim, damage, liability, or expense, as well as to reflect any other relevant equitable considerations. The relative fault of the indemnifying party and of the indemnified party shall be determined by reference to, among other things, whether the untrue or allegedly untrue statement of a material fact, or the omission or alleged omission of a material fact, relates to information supplied by the indemnifying party or by the indemnified party and the parties' relative intent, knowledge, access to information, and opportunity to correct or prevent such statement or omission; provided, however, that, in any such case, (x) no Holder will be required to contribute any amount in excess of the public offering price of all such Registrable Securities offered and sold by such Holder pursuant to such registration statement, and (y) no Person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the Securities Act) will be entitled to contribution from any Person who was not guilty of such



fraudulent misrepresentation; and provided further that in no event shall a Holder's liability pursuant to this Subsection 2.8(d), when combined with the amounts paid or payable by such Holder pursuant to Subsection 2.8(b), exceed the proceeds from the offering received by such Holder (net of any Selling Expenses paid by such Holder), except in the case of willful misconduct or fraud by such Holder.

(e) [Notwithstanding the foregoing, to the extent that the provisions on indemnification and contribution contained in the underwriting agreement entered into in connection with the underwritten public offering are in conflict with the foregoing provisions, the provisions in the underwriting agreement shall control.]

(f) Unless otherwise superseded by an underwriting agreement entered into in connection with the underwritten public offering, the obligations of the Company and Holders under this Subsection 2.8 shall survive the completion of any offering of Registrable Securities in a registration under this Section 2, and otherwise shall survive the termination of this Agreement.

2.9 Reports Under Exchange Act. With a view to making available to the Holders the benefits of SEC Rule 144 and any other rule or regulation of the SEC that may at any time permit a Holder to sell securities of the Company to the public without registration or pursuant to a registration on Form S-3, the Company shall:

(a) make and keep available adequate current public information, as those terms are understood and defined in SEC Rule 144, at all times after the effective date of the registration statement filed by the Company for the IPO;

(b) use commercially reasonable efforts to file with the SEC in a timely manner all reports and other documents required of the Company under the Securities Act and the Exchange Act (at any time after the Company has become subject to such reporting requirements); and

(c) furnish to any Holder, so long as the Holder owns any Registrable Securities, forthwith upon request (i) to the extent accurate, a written statement by the Company that it has complied with the reporting requirements of SEC Rule 144 (at any time after ninety (90) days after the effective date of the registration statement filed by the Company for the IPO), the Securities Act, and the Exchange Act (at any time after the Company has become subject to such reporting requirements), or that it qualifies as a registrant whose securities may be resold pursuant to Form S-3 (at any time after the Company so qualifies); [(ii) a copy of the most recent annual or quarterly report of the Company and such other reports and documents so filed by the Company;]<sup>21</sup> and (iii) such other information as may be reasonably requested in availing any Holder of any rule or regulation of the SEC that permits the selling of any such securities without registration (at any time after the Company has become subject to the reporting requirements

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<sup>21</sup> The value and necessity of obligations to provide copies of SEC filed documents is questionable given the availability of all such documents on EDGAR.

under the Exchange Act) or pursuant to Form S-3 (at any time after the Company so qualifies to use such form).

2.10 Limitations on Subsequent Registration Rights. From and after the date of this Agreement, the Company shall not, without the prior written consent of the Holders of [a majority of] the Registrable Securities then outstanding, enter into any agreement with any holder or prospective holder of any securities of the Company that (i) would [provide to such holder the right to include securities in any registration on other than either a pro rata basis with respect to the Registrable Securities or on a subordinate basis after all Holders have had the opportunity to include in the registration and offering all shares of Registrable Securities that they wish to so include][allow such holder or prospective holder (i) to include such securities in any registration unless, under the terms of such agreement, such holder or prospective holder may include such securities in any such registration only to the extent that the inclusion of such securities will not reduce the number of the Registrable Securities of the Holders that are included] [or (ii) allow such holder or prospective holder to initiate a demand for registration of any securities held by such holder or prospective holder]; provided that this limitation shall not apply to any additional Investor who becomes a party to this Agreement in accordance with Subsection 6.9.<sup>22</sup>

2.11 “Market Stand-off” Agreement.<sup>23</sup> Each Holder hereby agrees that it will not, without the prior written consent of the managing underwriter, during the period commencing on the date of the final prospectus relating to the registration by the Company [for its own behalf] of shares of its Common Stock or any other equity securities under the Securities Act on a registration statement on Form S-1 or Form S-3],<sup>24</sup> and ending on the date specified by the Company and the managing underwriter (such period not to exceed one hundred eighty (180) days in the case of the IPO[, or such other period as may be requested by the Company or an underwriter to accommodate regulatory restrictions on (1) the publication or other distribution of research reports and (2) analyst recommendations and opinions, including, but not limited to, the restrictions contained in FINRA Rule 2711(f)(4) or NYSE Rule 472(f)(4), or any successor provisions or amendments thereto)],<sup>25</sup> [or (y) ninety (90) days in the case of any registration

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<sup>22</sup> Attention should be given to ensure that this provision does not provide any particular investor with a blocking right on future securities issuances beyond what is included in the Certificate of Incorporation.

<sup>23</sup> This section sets forth the period during which the investors and other holders will be prohibited from selling their securities following the IPO and potentially other registrations. The lockup agreement will be required by the underwriter of the offering and is usually set at 180 days for an IPO, because this is the time period most underwriters typically require. Because the principal investors in the Company will almost certainly be required to provide whatever lock-up agreement is requested by the underwriters in order for an offering to be successful, the greatest value of the lock-up provision may be to ensure a similar lock-up of shares held by the smaller holders of Company stock.

<sup>24</sup> The bracketed language provides for additional lock-ups for registrations other than the IPO. Some investors may have issues with being locked-up for any registration other than the IPO but others may prefer to have this provision in order to help ensure the success of any subsequent offering. A compromise position might be to say that with respect to any offering other than the IPO the Holders would be subject to a lock-up if requested by the managing underwriter and approved by Holders of X% of the Registrable Securities.

<sup>25</sup> The bracketed language is intended to address the fact that FINRA Rule 2711(f)(4) and NYSE Rule 472 each prohibit the publication or other distribution of a research report or the making of a public appearance concerning a subject company by a member 15 days prior to and after the expiration, waiver or termination of a

other than the IPO[, or such other period as may be requested by the Company or an underwriter to accommodate regulatory restrictions on (1) the publication or other distribution of research reports and (2) analyst recommendations and opinions, including, but not limited to, the restrictions contained in FINRA Rule 2711(f)(4) or NYSE Rule 472(f)(4), or any successor provisions or amendments thereto)], (i) lend; offer; pledge; sell; contract to sell; sell any option or contract to purchase; purchase any option or contract to sell; grant any option, right, or warrant to purchase; or otherwise transfer or dispose of, directly or indirectly, any shares of Common Stock or any securities convertible into or exercisable or exchangeable (directly or indirectly) for Common Stock [(whether such shares or any such securities are then owned by the Holder or are thereafter acquired)] [*Alternative*: held immediately before the effective date of the registration statement for such offering]<sup>26</sup> or (ii) enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of such securities, whether any such transaction described in clause (i) or (ii) above is to be settled by delivery of Common Stock or other securities, in cash, or otherwise. The foregoing provisions of this Subsection 2.11 [shall apply only to the IPO,] shall not apply to the sale of any shares to an underwriter pursuant to an underwriting agreement, [or the transfer of any shares to any trust for the direct or indirect benefit of the Holder or the immediate family of the Holder, provided that the trustee of the trust agrees to be bound in writing by the restrictions set forth herein, and provided further that any such transfer shall not involve a disposition for value,] and shall be applicable to the Holders only if all officers and directors are subject to the same restrictions [and the Company uses commercially reasonable efforts to obtain a similar agreement from all stockholders individually owning more than [one-five] percent ([1-5]%) of the Company's outstanding Common Stock (after giving effect to conversion into Common Stock of all outstanding [Series A] Preferred Stock)<sup>27</sup>]. The underwriters in connection with such registration are intended third-party beneficiaries of this Subsection 2.11 and shall have the right, power, and authority to enforce the provisions hereof as though they were a party hereto. Each Holder further agrees to execute such agreements as may be reasonably requested by the underwriters in connection with such registration that are consistent with this Subsection 2.11 or that are necessary to give further effect thereto. [Any discretionary waiver or termination of the restrictions of any or all of such agreements by the Company or the underwriters shall apply pro rata to all Holders subject to such agreements, based on the number of shares subject to such

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lock-up agreement or any other agreement that the member has entered into with a subject company or its shareholders that restricts or prohibits the sale of securities held by the subject company or its shareholders after the completion of a securities offering, unless the securities are "actively traded" within the meaning of Rule 101(c)(1) of Regulation M under the Exchange Act. Some underwriters are actually going farther and requiring that lockup periods be extended to up to a total of 210 days in order to give them sufficient leeway.

<sup>26</sup> Investors typically request that common stock acquired in the IPO or in the public market after the IPO should not be subject to the lockup provisions.

<sup>27</sup> An alternative, commonly used provision requires the Company to obtain a lock-up from all directors and officers and all stockholders individually owning more than [one-five] percent ([1-5]%) of the Company's outstanding Common Stock (after giving effect to conversion into Common Stock of all outstanding Preferred Stock). A potential problem with such formulation is that if not all larger stockholders are parties to this agreement or otherwise subject to the same restrictions then the failure to obtain a lock-up from even a single one of those stockholders would invalidate the entire provision. Consider also including a covenant requiring all future stockholders to sign a similar market stand-off provision. Compare Subsection 5.3, which applies only to employees.

agreements[, except that, notwithstanding the foregoing, the Company and the underwriters may, in their sole discretion, waive or terminate these restrictions with respect to up to [\_\_\_\_\_] shares of the Common Stock].]<sup>28</sup>

## 2.12 Restrictions on Transfer.<sup>29</sup>

(a) The [Series A] Preferred Stock and the Registrable Securities shall not be sold, pledged, or otherwise transferred, and the Company shall not recognize and shall issue stop-transfer instructions to its transfer agent with respect to any such sale, pledge, or transfer, except upon the conditions specified in this Agreement, which conditions are intended to ensure compliance with the provisions of the Securities Act. A transferring Holder will cause any proposed purchaser, pledgee, or transferee of the [Series A] [Preferred Stock] and the Registrable Securities held by such Holder to agree to take and hold such securities subject to the provisions and upon the conditions specified in this Agreement.

(b) Each certificate or instrument representing (i) the [Series A] Preferred Stock, (ii) the Registrable Securities, and (iii) any other securities issued in respect of the securities referenced in clauses (i) and (ii), upon any stock split, stock dividend, recapitalization, merger, consolidation, or similar event, shall (unless otherwise permitted by the provisions of Subsection 2.12(c)) be stamped or otherwise imprinted with a legend substantially in the following form:

THE SECURITIES REPRESENTED HEREBY HAVE BEEN ACQUIRED FOR INVESTMENT AND HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933. SUCH SHARES MAY NOT BE SOLD, PLEDGED, OR TRANSFERRED IN THE ABSENCE OF SUCH REGISTRATION OR A VALID EXEMPTION FROM THE REGISTRATION AND PROSPECTUS DELIVERY REQUIREMENTS OF SAID ACT.

THE SECURITIES REPRESENTED HEREBY MAY BE TRANSFERRED ONLY IN ACCORDANCE WITH THE TERMS OF AN AGREEMENT BETWEEN THE COMPANY AND THE STOCKHOLDER, A COPY OF WHICH IS ON FILE WITH THE SECRETARY OF THE COMPANY.

The Holders consent to the Company making a notation in its records and giving instructions to any transfer agent of the Restricted Securities in order to implement the restrictions on transfer set forth in this Subsection 2.12.

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<sup>28</sup> Sometimes *de minimis* thresholds are negotiated so that smaller employee stockholders in need of liquidity can be released without destroying all of the lockups and the offering. Note, however, that based on very recent experience with dealing with IPO underwriters, who are objecting to small holders not being subject to lock-ups, some funds are requiring that all stockholders be subject to lock-ups.

<sup>29</sup> This Agreement does not prohibit the transfer of Registrable Securities to competitors. Some companies insist on providing for a flat prohibition on transfers to competitors; a less restrictive alternative would be to provide for a “right of first refusal” in favor of the Company, other investors, or Key Holders in the event of a proposed sale or transfer to a competitor. See also Subsections 3.1, 3.2 and 3.3.

(c) The holder of each certificate representing Restricted Securities, by acceptance thereof, agrees to comply in all respects with the provisions of this Section 2. Before any proposed sale, pledge, or transfer of any Restricted Securities, unless there is in effect a registration statement under the Securities Act covering the proposed transaction, the Holder thereof shall give notice to the Company of such Holder's intention to effect such sale, pledge, or transfer. Each such notice shall describe the manner and circumstances of the proposed sale, pledge, or transfer in sufficient detail and, if reasonably requested by the Company, shall be accompanied at such Holder's expense by either (i) a written opinion of legal counsel who shall, and whose legal opinion shall, be reasonably satisfactory to the Company, addressed to the Company, to the effect that the proposed transaction may be effected without registration under the Securities Act; (ii) a "no action" letter from the SEC to the effect that the proposed sale, pledge, or transfer of such Restricted Securities without registration will not result in a recommendation by the staff of the SEC that action be taken with respect thereto; or (iii) any other evidence reasonably satisfactory to counsel to the Company to the effect that the proposed sale, pledge, or transfer of the Restricted Securities may be effected without registration under the Securities Act, whereupon the Holder of such Restricted Securities shall be entitled to sell, pledge, or transfer such Restricted Securities in accordance with the terms of the notice given by the Holder to the Company. The Company will not require such a legal opinion or "no action" letter (x) in any transaction in compliance with SEC Rule 144 or (y) in any transaction in which such Holder distributes Restricted Securities to an Affiliate of such Holder for no consideration; provided that each transferee agrees in writing to be subject to the terms of this Subsection 2.12. Each certificate or instrument evidencing the Restricted Securities transferred as above provided shall bear, except if such transfer is made pursuant to SEC Rule 144, the appropriate restrictive legend set forth in Subsection 2.12(b), except that such certificate shall not bear such restrictive legend if, in the opinion of counsel for such Holder and the Company, such legend is not required in order to establish compliance with any provisions of the Securities Act.

2.13 Termination of Registration Rights. The right of any Holder to request registration or inclusion of Registrable Securities in any registration pursuant to Subsection 2.1 or Subsection 2.2 shall terminate upon [the earliest to occur of]:

(a) [the closing of a Deemed Liquidation Event, as such term is defined in the Company's Certificate of Incorporation;]

(b) [such time as Rule 144 or another similar exemption under the Securities Act is available for the sale of all of such Holder's shares without limitation during a three-month period without registration; and]<sup>30</sup>

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<sup>30</sup> Investors should be aware of definitions providing that shares cease to be registrable when they "may" be sold to the public without limitation as to amount (most often couched in the Rule 144 context). This variation may not be acceptable to investors, for several reasons. First, investors specifically negotiate for registration rights so that they are afforded the opportunity for a marketed and orderly exit from their investment, and the exemption from registration afforded by Rule 144 should not change this. Second, this provision could result in differing treatment of investors in that certain investors may be affiliates of the Company (due to, for example, Board representation or percentage stock ownership) for whom Rule 144 may not be available for sale of all shares without volume limitations, resulting in no loss of registration rights, while other investors who are not

(c) the [\_\_\_\_\_] anniversary of the [IPO] [*Alternative: date of this Agreement*].

### 3. Information and Observer Rights.

3.1 Delivery of Financial Statements. The Company shall deliver to each Major Investor<sup>31</sup>[, provided that the Board of Directors has not reasonably determined that such Major Investor is a competitor of the Company<sup>32</sup>]:

(a) as soon as practicable, but in any event within [ninety (90)-one hundred twenty (120)] days after the end of each fiscal year of the Company, (i) a balance sheet as of the end of such year, (ii) statements of income and of cash flows for such year[, and a comparison between (x) the actual amounts as of and for such fiscal year and (y) the comparable amounts for the prior year and as included in the Budget (as defined in Subsection 3.1(e)) for such year, with an explanation of any material differences between such amounts and a schedule as to the sources and applications of funds for such year], and (iii) a statement of stockholders' equity as of the end of such year[, all such financial statements audited and certified by independent public accountants of [nationally] [regionally] recognized standing selected by the Company];<sup>33</sup>

(b) as soon as practicable, but in any event within forty-five (45) days after the end of each of the first three (3) quarters of each fiscal year of the Company, unaudited

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affiliates of the Company and for whom Rule 144 would become available for sale of all shares without volume limitations would lose registration rights. Finally, depending on factors such as holding periods, lockup periods, and market volumes, investors may lose their registration rights without any real opportunity to exercise them if the rights expire when shares become salable on an unlimited basis under Rule 144. This final point is particularly true with the reduction of the holding period under Rule 144 for unlimited resales of securities (other than for affiliates) to one year. Sometimes investors agree to minimum ownership thresholds such that holders of securities available for sale under Rule 144 who hold less than a specified percentage (usually 1%-5%) of the Company lose registration rights. The idea behind this is that these smaller holders really should be using Rule 144 as an exit strategy. If investors can get comfortable with the percentage threshold (which may be difficult since they will have to estimate some amount of dilution for additional financings and a possible IPO), this can be beneficial to the investors as well since it will reduce the crowd on the registration statement. In addition, some investors have expressed concern with termination of their registration rights even when all of their shares could be sold under Rule 144 since there may still be practical issues with such sales in large volumes (*e.g.*, someone holding 5-9%) even though they are legally permissible and some investors feel it may also be in the Company's interest to have them sell as part of an offering rather than dump the shares on the market. Investors also worry about such a termination provision in the event that they remain subject to continuing lock-ups for registrations other than the IPO (see footnote 24) as that can impact their ability to sell outside of the registration.

<sup>31</sup> The share-ownership minimum for receiving financial information is negotiable, but is often set at the holdings of the smallest venture capital investor. It should be set high enough to avoid burdensome disclosure requirements on the Company, but low enough to provide investors with information if they really need it.

<sup>32</sup> This provision grants the Board the discretion to define "competitor," but there are alternative ways that are more investor-friendly. For example, "competitors" could be defined as a select group of companies on a schedule.

<sup>33</sup> Consider the Company's stage of development, costs, and timing associated with audited financial statements as well as the use of nationally vs. regionally recognized accountants. Further, as a practical matter, "nationally recognized" accounting firms may not readily accept engagements by early stage companies.

statements of income and of cash flows for such fiscal quarter, and an unaudited balance sheet [and a statement of stockholders' equity] as of the end of such fiscal quarter, all prepared in accordance with GAAP (except that such financial statements may (i) be subject to normal year-end audit adjustments and (ii) not contain all notes thereto that may be required in accordance with GAAP);

(c) [as soon as practicable, but in any event within forty-five (45) days after the end of each of the first three (3) quarters of each fiscal year of the Company, a statement showing the number of shares of each class and series of capital stock and securities convertible into or exercisable for shares of capital stock outstanding at the end of the period, the Common Stock issuable upon conversion or exercise of any outstanding securities convertible or exercisable for Common Stock and the exchange ratio or exercise price applicable thereto, and the number of shares of issued stock options and stock options not yet issued but reserved for issuance, if any, all in sufficient detail as to permit the Major Investors to calculate their respective percentage equity ownership in the Company, and certified by the chief financial officer or chief executive officer of the Company as being true, complete, and correct];

(d) [as soon as practicable, but in any event within thirty (30) days of the end of each month, an unaudited income statement [and statement of cash flows] for such month, and an unaudited balance sheet [and statement of stockholders' equity] as of the end of such month, all prepared in accordance with GAAP (except that such financial statements may (i) be subject to normal year-end audit adjustments and (ii) not contain all notes thereto that may be required in accordance with GAAP);]

(e) as soon as practicable, but in any event thirty (30) days before the end of each fiscal year, a budget and business plan for the next fiscal year (collectively, the “**Budget**”), [approved by the Board of Directors and] prepared on a monthly basis, including balance sheets, income statements, and statements of cash flow for such months and, promptly after prepared, any other budgets or revised budgets prepared by the Company;

(f) [with respect to the financial statements called for in Subsection 3.1(a), Subsection 3.1(b) [and Subsection 3.1(d)], an instrument executed by the chief financial officer and chief executive officer of the Company certifying that such financial statements were prepared in accordance with GAAP consistently applied with prior practice for earlier periods (except as otherwise set forth in Subsection 3.1(b) [and Subsection 3.1(d)]) and fairly present the financial condition of the Company and its results of operation for the periods specified therein; and]

(g) [such other information<sup>34</sup> relating to the financial condition, business, prospects, or corporate affairs of the Company as any Major Investor may from time to time reasonably request; provided, however, that the Company shall not be obligated under this Subsection 3.1 to provide information (i) that the Company reasonably determines in good faith

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<sup>34</sup> Some investors request that the Company provide information relating to material litigation, regulatory matters, material defaults under credit facilities, and other material events and occurrences. Note, however, that if the investing entity is entitled to a Board seat, there is little need (at least for that particular investor) to impose these additional reporting obligations on the Company.

to be a trade secret or confidential information (unless covered by an enforceable confidentiality agreement, in form acceptable to the Company) or (ii) the disclosure of which would adversely affect the attorney-client privilege between the Company and its counsel.]

If, for any period, the Company has any subsidiary whose accounts are consolidated with those of the Company, then in respect of such period the financial statements delivered pursuant to the foregoing sections shall be the consolidated and consolidating financial statements of the Company and all such consolidated subsidiaries.

Notwithstanding anything else in this Subsection 3.1 to the contrary, the Company may cease providing the information set forth in this Subsection 3.1 during the period starting with the date [thirty (30) - sixty (60)] days before the Company's good-faith estimate of the date of filing of a registration statement if it reasonably concludes it must do so to comply with the SEC rules applicable to such registration statement and related offering; provided that the Company's covenants under this Subsection 3.1 shall be reinstated at such time as the Company is no longer actively employing its commercially reasonable efforts to cause such registration statement to become effective.

3.2 Inspection. The Company shall permit each Major Investor [(provided that the Board of Directors has not reasonably determined that such Major Investor is a competitor of the Company)], at such Major Investor's expense, to visit and inspect the Company's properties; examine its books of account and records; and discuss the Company's affairs, finances, and accounts with its officers, during normal business hours of the Company as may be reasonably requested by the Major Investor; provided, however, that the Company shall not be obligated pursuant to this Subsection 3.2 to provide access to any information that it reasonably and in good faith considers to be a trade secret or confidential information (unless covered by an enforceable confidentiality agreement, in form acceptable to the Company) or the disclosure of which would adversely affect the attorney-client privilege between the Company and its counsel.

3.3 [Observer Rights. As long as [\_\_\_\_\_] owns not less than [\_\_\_\_\_] percent [(\_\_\_\_%)] of the shares of the [Series A] Preferred Stock it is purchasing under the Purchase Agreement (or an equivalent amount of Common Stock issued upon conversion thereof), the Company shall invite a representative of [\_\_\_\_\_] to attend all meetings of its Board of Directors in a nonvoting observer capacity and, in this respect, shall give such representative copies of all notices, minutes, consents, and other materials that it provides to its directors [at the same time and in the same manner as provided to such directors]; provided, however, that such representative shall agree to hold in confidence and trust and to act in a fiduciary manner with respect to all information so provided; and provided further, that the Company reserves the right to withhold any information and to exclude such representative from any meeting or portion thereof if access to such information or attendance at such meeting could adversely affect the attorney-client privilege between the Company and its counsel or result in disclosure of trade



secrets or a conflict of interest, or if such Investor or its representative is a competitor of the Company.]<sup>35</sup>

3.4 Termination of Information [and Observer Rights]. The covenants set forth in Subsection 3.1 [,] [and] Subsection 3.2 [, and] Subsection 3.3] shall terminate and be of no further force or effect (i) immediately before the consummation of the IPO,<sup>36</sup> [or] (ii) when the Company first becomes subject to the periodic reporting requirements of Section 12(g) or 15(d) of the Exchange Act, [or (iii) upon a Deemed Liquidation Event, as such term is defined in the Company's Certificate of Incorporation,] whichever event occurs first.

3.5 Confidentiality. Each Investor agrees that such Investor will keep confidential and will not disclose, divulge, or use for any purpose (other than to monitor its investment in the Company) any confidential information obtained from the Company pursuant to the terms of this Agreement (including notice of the Company's intention to file a registration statement), unless such confidential information (a) is known or becomes known to the public in general (other than as a result of a breach of this Subsection 3.5 by such Investor), (b) is or has been independently developed or conceived by the Investor without use of the Company's confidential information, or (c) is or has been made known or disclosed to the Investor by a third party without a breach of any obligation of confidentiality such third party may have to the Company; provided, however, that an Investor may disclose confidential information (i) to its attorneys, accountants, consultants, and other professionals to the extent necessary to obtain their services in connection with monitoring its investment in the Company; (ii) to any prospective purchaser of any Registrable Securities from such Investor, if such prospective purchaser agrees to be bound by the provisions of this Subsection 3.5;<sup>37</sup> (iii) to any [existing or prospective]<sup>38</sup> Affiliate, partner, member, stockholder, or wholly owned subsidiary of such Investor in the ordinary course of business, provided that such Investor informs such Person that such information is confidential and directs such Person to maintain the confidentiality of such information; or (iv) as may otherwise be required by law, provided that the Investor promptly notifies the Company of such disclosure and takes reasonable steps to minimize the extent of any such required disclosure.

#### 4. Rights to Future Stock Issuances.

4.1 Right of First Offer. Subject to the terms and conditions of this Subsection 4.1 and applicable securities laws, if the Company proposes to offer or sell any New

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<sup>35</sup> Some companies prefer to include such provisions in an agreement between the Company and the particular investor receiving such rights, *e.g.*, in the Management Rights letter. Also, consider requiring Board observers to enter into confidentiality agreements before exercising any observer rights, since observers are not bound by the same fiduciary duties as directors.

<sup>36</sup> Because the Company will be a reporting company under the Exchange Act following any registered public offering, the Company will be required to limit information provided to Investors to the information filed with the SEC under the Exchange Act.

<sup>37</sup> Consider including language to prohibit disclosure of confidential information to any competitor.

<sup>38</sup> The bracketed language is a (pro-investor) provision intended to give Investors the ability to provide such information to prospective limited partners, members and other investors which may be important to an Investor, though note that companies may be uncomfortable extending the group which has access to their confidential information this far and may prefer to deal with this issue on a case by case basis.

Securities, the Company shall first offer such New Securities to each Major Investor.<sup>39</sup> A Major Investor shall be entitled to apportion the right of first offer hereby granted to it, in such proportions as it deems appropriate, among (i) itself, (ii) its Affiliates [and (iii) its beneficial interest holders, such as limited partners, members or any other Person having “beneficial ownership,” as such term is defined in Rule 13d-3 promulgated under the Exchange Act, of such Major Investor (“**Investor Beneficial Owners**”); provided that, each such Affiliate or Investor Beneficial Owner: (x) is not a Competitor or FOIA Party, unless such party’s purchase of New Securities is otherwise consented to by the Board of Directors, (y) agrees to enter into this Agreement and each of the Voting Agreement and Right of First Refusal and Co-Sale Agreement of even date herewith among the Company, the Investors and the other parties named therein, as an “**Investor**” under each such agreement (provided that, any Competitor or FOIA Party shall not be entitled to any rights as a Major Investor under Subsections 3.1, 3.2 and 4.1 hereof), and (z) agrees to purchase at least such number of New Securities as are allocable hereunder to the Major Investor holding the fewest number of [Series A] Preferred Stock and any other Derivative Securities].

(a) The Company shall give notice (the “**Offer Notice**”) to each Major Investor, stating (i) its bona fide intention to offer such New Securities, (ii) the number of such New Securities to be offered, and (iii) the price and terms, if any, upon which it proposes to offer such New Securities.

(b) By notification to the Company within twenty (20) days after the Offer Notice is given, each Major Investor may elect to purchase or otherwise acquire, at the price and on the terms specified in the Offer Notice, up to that portion of such New Securities<sup>40</sup> which equals the proportion that the Common Stock then held by such Major Investor (including all shares of Common Stock then issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of the [Series A] Preferred Stock and any other Derivative Securities then held by such Major Investor) bears to the total Common Stock of the Company [then outstanding (assuming full conversion and/or exercise, as applicable, of all [Series A] Preferred Stock and other Derivative Securities)] [*Alternative:* then held by all the Major Investors (including all shares of Common Stock issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of the [Series A] Preferred Stock and any other Derivative Securities then held by the Major Investors)].<sup>41</sup> At the expiration of such twenty (20) day period, the Company shall

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<sup>39</sup> Here this right is provided to only a few select investors (“**Major Investors**”), to avoid unduly complicating subsequent financing rounds.

<sup>40</sup> The Board may elect to reserve only a portion of the round for existing investors, with the balance to be offered exclusively to new investors. If so, then the phrase “set aside by the Board of Directors for purchase by existing investors” or similar language should be inserted immediately before the footnote reference above. (See similar language in definition of “Offered Securities” in pay-to-play section (“**Special Mandatory Conversion**”) of Model Certificate of Incorporation.) Some investors might view a provision authorizing the Board to allocate only a portion of the New Securities for purchase under Section 4 as eviscerating the investors’ right of first offer unless a minimum portion of the new offering must be set aside. Consequently, existing stockholders will usually be entitled to subscribe for all New Securities but will waive their rights in order to facilitate investment by new investors.

<sup>41</sup> The definition of this pro rata participation concept can be subject to negotiation. The numerator is generally based on common stock ownership or entitlement and should only include amounts held by the investor, including any shares of common stock that the investor may have purchased as common stock (for example, in a secondary transaction). The denominator is usually the fully diluted common stock of the Company before the

promptly notify each Major Investor that elects to purchase or acquire all the shares available to it (each, a “**Fully Exercising Investor**”) of any other Major Investor’s failure to do likewise. During the ten (10) day period commencing after the Company has given such notice, each Fully Exercising Investor may, by giving notice to the Company, elect to purchase or acquire, in addition to the number of shares specified above, up to that portion of the New Securities for which Major Investors were entitled to subscribe but that were not subscribed for by the Major Investors which is equal to the proportion that the Common Stock issued and held, or issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of [Series A] Preferred Stock and any other Derivative Securities then held, by such Fully Exercising Investor bears to the Common Stock issued and held, or issuable (directly or indirectly) upon conversion and/or exercise, as applicable, of the [Series A] Preferred Stock and any other Derivative Securities then held, by all Fully Exercising Investors who wish to purchase such unsubscribed shares.<sup>42</sup> The closing of any sale pursuant to this Subsection 4.1(b) shall occur within the later of [ninety/one hundred and twenty (90/120)] days of the date that the Offer Notice is given and the date of initial sale of New Securities pursuant to Subsection 4.1(c).

(c) If all New Securities referred to in the Offer Notice are not elected to be purchased or acquired as provided in Subsection 4.1(b), the Company may, during the [ninety (90)] day period following the expiration of the periods provided in Subsection 4.1(b), offer and sell the remaining unsubscribed portion of such New Securities to any Person or Persons at a price not less than, and upon terms no more favorable to the offeree than, those specified in the Offer Notice. If the Company does not enter into an agreement for the sale of the New Securities within such period, or if such agreement is not consummated within [thirty (30)] days of the execution thereof, the right provided hereunder shall be deemed to be revived and such New Securities shall not be offered unless first reoffered to the Major Investors in accordance with this Subsection 4.1.

(d) The right of first offer in this Subsection 4.1 shall not be applicable to<sup>43</sup> (i) Exempted Securities (as defined in the Company’s Certificate of Incorporation); [and] (ii) shares of Common Stock issued in the IPO[; and (iii) the issuance of shares of [Series A] Preferred Stock to Additional Purchasers pursuant to Subsection [1.3] of the Purchase Agreement.]

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issuance but can sometimes be cut back to exclude certain options or warrants, thereby increasing the number of shares available for purchase by holders of the purchase right, or can be limited (as in the alternative bracketed language) to securities held by the group with the purchase right (here, Major Investors), thereby making the purchase right a preemptive right in favor of such group.

<sup>42</sup> This is commonly referred to as a “gobble-up,” “over allotment,” or “oversubscription” provision and allows investors to purchase shares not purchased by other investors entitled to purchase rights. This is usually easy to negotiate, but some companies may resist allowing investors to exceed their current percentage ownership in the Company (which could limit shares available to potential new investors).

<sup>43</sup> These provisions should generally be consistent with the carve-outs to antidilution protection contained in the Certificate of Incorporation. However, additional exclusions may be negotiated, and more Company flexibility may be afforded here than in the similar antidilution carve-outs in the Certificate of Incorporation, since preemptive rights are usually considered a less important investor right than a conversion price adjustment.

(e) [The right of first offer set forth in this Subsection 4.1 shall terminate with respect to any Major Investor who fails to purchase, in any transaction subject to this Subsection 4.1, all of such Major Investor's pro rata amount of the New Securities allocated (or, if less than such Major Investor's pro rata amount is offered by the Company, such lesser amount so offered) to such Major Investor pursuant to this Subsection 4.1. Following any such termination, such Investor shall no longer be deemed a "Major Investor" for any purpose of this Subsection 4.1.]

(f) [Notwithstanding any provision hereof to the contrary, in lieu of complying with the provisions of this Subsection 4.1, the Company may elect to give notice to the Major Investors within thirty (30) days after the issuance of New Securities. Such notice shall describe the type, price, and terms of the New Securities. Each Major Investor shall have twenty (20) days from the date notice is given to elect to purchase up to the number of New Securities that would, if purchased by such Major Investor, maintain such Major Investor's percentage-ownership position, calculated as set forth in Subsection 4.1(b) before giving effect to the issuance of such New Securities. If this provision is included in the Agreement, careful attention should be paid to the denominator used in the calculation of the pro rata participation right. Note that this language will not work if Section 4.1 has been set up to give the investors a preemptive right. See footnote 41.<sup>44</sup> The closing of such sale shall occur within sixty (60) days of the date notice is given to the Major Investors.]

#### 4.2 [Directed IPO Shares.]<sup>45</sup>

4.3 Termination. The covenants set forth in Subsection 4.1 [and Subsection 4.2] shall terminate and be of no further force or effect (i) immediately before the consummation of the IPO, (ii) when the Company first becomes subject to the periodic reporting requirements of Section 12(g) or 15(d) of the Exchange Act, [or (iii) upon a Deemed Liquidation Event, as such term is defined in the Company's Certificate of Incorporation,] whichever event occurs first [and, as to each Major Investor, in accordance with Subsection 4.1(e)].

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<sup>44</sup> If this provision is included in the Agreement, careful attention should be paid to the denominator used in the calculation of the pro rata participation right. Note that this language will not work if Section 4.1 has been set up to give the investors a preemptive right. See footnote 41.

<sup>45</sup> Provisions relating to directed IPO shares are no longer common in venture financing documents. A form of directed share covenant is set forth below:

If an IPO is undertaken, the Company will use its commercially reasonable efforts to cause the managing underwriter(s) of the IPO to designate a number of shares equal to [ten percent (10%)] of the Common Stock to be offered in the IPO for sale under a "directed shares program" and shall instruct such underwriter(s) to allocate no less than fifty percent (50%) of such directed shares program to be sold to Persons designated by the Major Investors pro rata on the basis of the number of shares held by each of the Major Investors (on an as-converted basis). The shares designated by the underwriter(s) for sale under a directed shares program are referred to herein as "directed shares." The Major Investors acknowledge that, despite the Company's use of its commercially reasonable efforts, the underwriter(s) may determine in [its/their] sole discretion that it is not advisable to designate all such shares as directed shares in the IPO, in which case the number of directed shares may be reduced or no directed shares may be designated, as applicable. The Major Investors also acknowledge that notwithstanding the terms of this Agreement, the sale of any directed shares to any Person pursuant to this Agreement will only be made in compliance with Rules 2110 and 2790 of the National Association of Securities Dealers, Inc. Conduct Rules and federal, state, and local laws, rules, and regulations, and only if the IPO is consummated after one (1) year from the date hereof.

5. Additional Covenants.

5.1 Insurance. The Company shall use its commercially reasonable efforts to obtain, within ninety (90) days of the date hereof, from financially sound and reputable insurers Directors and Officers liability insurance and term “key-person” insurance on [\_\_\_\_], each in an amount and on terms and conditions satisfactory to the Board of Directors, and will use commercially reasonable efforts to cause such insurance policies to be maintained until such time as the Board of Directors determines that such insurance should be discontinued. The key-person policy shall name the Company as loss payee, and neither policy shall be cancelable by the Company without prior approval by the Board of Directors [including the Series A Director][and holders of a [majority] of the Preferred Stock]. [Each Key Holder hereby covenants and agrees that, to the extent such Key Holder is named under such key-person policy, such Key Holder will execute and deliver to the Company, as reasonably requested, a written notice and consent form with respect to such policy.]<sup>46</sup>

5.2 Employee Agreements. The Company will cause (i) each person now or hereafter employed by it or by any subsidiary (or engaged by the Company or any subsidiary as a consultant/independent contractor) with access to confidential information and/or trade secrets to enter into a nondisclosure and proprietary rights assignment agreement and (ii) each Key Employee to enter into a [one (1)] year noncompetition and nonsolicitation agreement[, substantially in the form approved by the Board of Directors][, in the form attached hereto as Exhibit A].<sup>47</sup> In addition, the Company shall not amend, modify, terminate, waive, or otherwise alter, in whole or in part, any of the above-referenced agreements or any restricted stock agreement between the Company and any employee, without the [unanimous] consent of the Series A Directors.

5.3 Employee Stock. Unless otherwise approved by the Board of Directors, [including the Series A Director,] all future employees and consultants of the Company who purchase, receive options to purchase, or receive awards of shares of the Company’s capital stock after the date hereof shall be required to execute restricted stock or option agreements, as applicable, providing for (i) vesting of shares over a [four (4)] year period, with the first [twenty-five percent (25%)] of such shares vesting following [twelve (12)] months of continued employment or service, and the remaining shares vesting in equal [monthly] installments over the following [thirty-six (36) months], and (ii) a market stand-off provision substantially similar to that in Subsection 2.11. In addition, unless otherwise approved by the Board of Directors, [including the Series A Director,] the Company shall retain a “right of first refusal” on employee

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<sup>46</sup> Such notice and consent may be required in order for proceeds payable under a key-person policy not to constitute taxable income to the company. The company is advised to review the taxation of policy proceeds with an insurance broker.

<sup>47</sup> Note that noncompete restrictions (other than in connection with the sale of a business) are prohibited in California and may not be enforceable in other jurisdictions. In addition, some investors do not require such agreements for fear that employees will request additional consideration in exchange for signing a noncompete/nonsolicit (and indeed the agreement may arguably be invalid absent such additional consideration). Others take the view that it should be up to the Board on a case-by-case basis to determine whether any particular key employee is required to sign such an agreement. Noncompetes typically have a one-year duration, although state law may permit up to two years.

transfers until the Company's IPO and shall have the right to repurchase unvested shares at cost upon termination of employment of a holder of restricted stock.

5.4 [Qualified Small Business Stock]. The Company shall use commercially reasonable efforts to cause the shares of [Series A] Preferred Stock [issued pursuant to the Purchase Agreement], as well as any shares into which such shares are converted, within the meaning of Section 1202(f) of the Internal Revenue Code (the "**Code**"), to constitute "qualified small business stock" as defined in Section 1202(c) of the Code; provided, however, that such requirement shall not be applicable if the Board of Directors of the Company determines, in its good-faith business judgment, that such qualification is inconsistent with the best interests of the Company. The Company shall submit to its stockholders (including the Investors) and to the Internal Revenue Service any reports that may be required under Section 1202(d)(1)(C) of the Code and the regulations promulgated thereunder. In addition, within twenty (20) business days after any Investor's written request therefor, the Company shall, at its option, either (i) deliver to such Investor a written statement indicating whether (and what portion of) such Investor's interest in the Company constitutes "qualified small business stock" as defined in Section 1202(c) of the Code or (ii) deliver to such Investor such factual information in the Company's possession as is reasonably necessary to enable such Investor to determine whether (and what portion of) such Investor's interest in the Company constitutes "qualified small business stock" as defined in Section 1202(c) of the Code.]

5.5 Matters Requiring Investor Director Approval.<sup>48</sup> So long as the holders of Series A Preferred Stock are entitled to elect a Series A Director, the Company hereby covenants and agrees with each of the Investors that it shall not, without approval of the Board of Directors, which approval must include the affirmative vote of [one/both] of the Series A Directors:<sup>49</sup>

(a) make, or permit any subsidiary to make, any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company;

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<sup>48</sup> There is a divergence of interest between the company and the investors with respect to whether specified corporate acts may be subject to approval by the investors' designee to the Board. In many cases, the investors won't go forward without this provision. In other cases, the topics of concern would otherwise be added to the Certificate of Incorporation and require a stockholder vote. The Company generally would find the director approval approach preferable, as the director representative on the Board has a fiduciary duty to the corporation when acting in the capacity of a director. Other formulations could be: requiring the vote of a supermajority of the Board, or a majority of the non-management directors.

<sup>49</sup> There may be other deal-specific provisions to include in this section. Also, there may be provisions herein that are not appropriate for every transaction. In general, parties should be mindful of balancing investor control with the duty of the Board to act in accordance with its fiduciary duties. These provisions should also be harmonized with the special investor approval rights (so-called "protective provisions") in the Certificate of Incorporation, to avoid overlap. Also, in determining whether stockholder approval or director approval is appropriate, consider (1) that the directors, unlike investors, have fiduciary duties; (2) that, as a practical matter, Board approval is easier to obtain than stockholder approval; and (3) the proportion of preferred shares held by funds whose partners sit on the Board. Also, consider adding protections similar to those contained in the Certificate of Incorporation.

(b) make, or permit any subsidiary to make, any loan or advance to any Person, including, without limitation, any employee or director of the Company or any subsidiary, except advances and similar expenditures in the ordinary course of business or under the terms of an employee stock or option plan approved by the Board of Directors;

(c) guarantee, directly or indirectly, or permit any subsidiary to guarantee, directly or indirectly, any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business;

(d) make any investment inconsistent with any investment policy approved by the Board of Directors;

(e) incur any aggregate indebtedness in excess of \$[\_\_\_\_\_] that is not already included in a budget approved by the Board of Directors, other than trade credit incurred in the ordinary course of business;

(f) otherwise enter into or be a party to any transaction with any director, officer, or employee of the Company or any “associate” (as defined in Rule 12b-2 promulgated under the Exchange Act) of any such Person, except for transactions contemplated by this Agreement, the Purchase Agreement, and [\_\_\_\_\_] [; transactions resulting in payments to or by the Company in an aggregate amount less than \$[60,000] per year] [; or transactions made in the ordinary course of business and pursuant to reasonable requirements of the Company’s business and upon fair and reasonable terms that are approved by a majority of the Board of Directors];

(g) hire, terminate, or change the compensation of the executive officers, including approving any option grants or stock awards to executive officers;

(h) change the principal business of the Company, enter new lines of business, or exit the current line of business;

(i) sell, assign, license, pledge, or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or

(j) enter into any corporate strategic relationship involving the payment, contribution, or assignment by the Company or to the Company of money or assets greater than \$[100,000].

5.6 Board Matters. Unless otherwise determined by the vote of a majority of the directors then in office, the Board of Directors shall meet at least [monthly] [quarterly] in accordance with an agreed-upon schedule. The Company shall reimburse the [nonemployee] directors for all reasonable out-of-pocket travel expenses incurred (consistent with the Company’s travel policy) in connection with attending meetings of the Board of Directors. [The Company shall cause to be established, as soon as practicable after such request, and will maintain, an audit and compensation committee, each of which shall consist solely of non-management directors. Each non-employee director shall be entitled in such person’s discretion to be a member of any Board committee.]

5.7 Successor Indemnification. If the Company or any of its successors or assignees consolidates with or merges into any other Person and is not the continuing or surviving corporation or entity of such consolidation or merger, then to the extent necessary, proper provision shall be made so that the successors and assignees of the Company assume the obligations of the Company with respect to indemnification of members of the Board of Directors as in effect immediately before such transaction, whether such obligations are contained in the Company's Bylaws, its Certificate of Incorporation, or elsewhere, as the case may be.

5.8 [Expenses of Counsel. In the event of a transaction which is a Sale of the Company (as defined in the Voting Agreement of even date herewith among the Investors and the Company), the reasonable fees and disbursements[, not to exceed \$\_\_\_\_,] of one counsel for the [Major] Investors (“**Investor Counsel**”), in their capacities as stockholders, shall be borne and paid by the Company. At the outset of considering a transaction which, if consummated would constitute a Sale of the Company, the Company shall obtain the ability to share with the Investor Counsel (and such counsel's clients) and shall share the confidential information (including without limitation the initial and all subsequent drafts of memoranda of understanding, letters of intent and other transaction documents and related noncompete, employment, consulting and other compensation agreements and plans) pertaining to and memorializing any of the transactions which, individually or when aggregated with others would constitute the Sale of the Company. The Company shall be obligated to share (and cause the Company's counsel and investment bankers to share) such materials when distributed to the Company's executives and/or any one or more of the other parties to such transaction(s). In the event that Investor Counsel deems it appropriate, in its reasonable discretion, to enter into a joint defense agreement or other arrangement to enhance the ability of the parties to protect their communications and other reviewed materials under the attorney client privilege, the Company shall, and shall direct its counsel to, execute and deliver to Investor Counsel and its clients such an agreement in form and substance reasonably acceptable to Investor Counsel. In the event that one or more of the other party or parties to such transactions require the clients of Investor Counsel to enter into a confidentiality agreement and/or joint defense agreement in order to receive such information, then the Company shall share whatever information can be shared without entry into such agreement and shall, at the same time, in good faith work expeditiously to enable Investor Counsel and its clients to negotiate and enter into the appropriate agreement(s) without undue burden to the clients of Investor Counsel.]<sup>50</sup>

5.9 [Indemnification Matters. The Company hereby acknowledges that one (1) or more of the directors nominated to serve on the Board of Directors by the Investors (each a “**Fund Director**”) may have certain rights to indemnification, advancement of expenses and/or insurance provided by one or more of the Investors and certain of their affiliates (collectively, the “**Fund Indemnitors**”). The Company hereby agrees (a) that it is the indemnitor of first resort (i.e., its obligations to any such Fund Director are primary and any obligation of the Fund

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<sup>50</sup> Investors at times find that their interests are not perfectly aligned with those of management when it comes to the Sale of a Company and/or that the matters of concern to them (e.g., escrow provisions) are not necessarily important to management; providing for separate investor counsel ensures that someone is looking out for their interests at a crucial time.



Indemnitors to advance expenses or to provide indemnification for the same expenses or liabilities incurred by such Fund Director are secondary), (b) that it shall be required to advance the full amount of expenses incurred by such Fund Director and shall be liable for the full amount of all expenses, judgments, penalties, fines and amounts paid in settlement by or on behalf of any such Fund Director to the extent legally permitted and as required by the Company's Certificate of Incorporation or Bylaws of the Company (or any agreement between the Company and such Fund Director), without regard to any rights such Fund Director may have against the Fund Indemnitors, and, (c) that it irrevocably waives, relinquishes and releases the Fund Indemnitors from any and all claims against the Fund Indemnitors for contribution, subrogation or any other recovery of any kind in respect thereof. The Company further agrees that no advancement or payment by the Fund Indemnitors on behalf of any such Fund Director with respect to any claim for which such Fund Director has sought indemnification from the Company shall affect the foregoing and the Fund Indemnitors shall have a right of contribution and/or be subrogated to the extent of such advancement or payment to all of the rights of recovery of such Fund Director against the Company.]<sup>51</sup>

5.10 Termination of Covenants. The covenants set forth in this Section 5, except for Subsection[s] 5.7 [and 5.8], shall terminate and be of no further force or effect [(i) immediately before the consummation of the IPO [or][(ii) when the Company first becomes subject to the periodic reporting requirements of Section 12(g) or 15(d) of the Exchange Act, or (iii) upon a Deemed Liquidation Event, as such term is defined in the Company's Certificate of Incorporation, whichever event occurs first].<sup>52</sup>

## 6. Miscellaneous.

6.1 Successors and Assigns. The rights under this Agreement may be assigned (but only with all related obligations) by a Holder to a transferee of Registrable Securities that (i) is an Affiliate of a Holder; (ii) is a Holder's Immediate Family Member or trust for the benefit of an individual Holder or one or more of such Holder's Immediate Family Members; or (iii) after such transfer, holds at least [\_\_\_\_\_] shares of Registrable Securities (subject to appropriate adjustment for stock splits, stock dividends, combinations, and other recapitalizations); provided, however, that (x) the Company is, within a reasonable time after such transfer, furnished with written notice of the name and address of such transferee and the Registrable Securities with respect to which such rights are being transferred; and (y) such transferee agrees in a written instrument delivered to the Company to be bound by and subject to the terms and conditions of this Agreement, including the provisions of Subsection 2.11. For the purposes of determining the number of shares of Registrable Securities held by a transferee, the holdings of a transferee (1) that is an Affiliate or stockholder of a Holder; (2) who is a Holder's Immediate Family Member; or (3) that is a trust for the benefit of an individual Holder or such Holder's Immediate Family Member shall be aggregated together and with those of the

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<sup>51</sup> This provision, added in the wake of the Delaware Chancery Court's decision in *Levy, et al. v. HLI Operating Company, Inc., et al.*, 2007 WL 1452934 (Del.Ch.), is designed to reinforce the priority of the company's indemnification of an investor director and to ensure that the investing entity itself is in direct contractual privity with the company with respect to such priority (in contrast to an indemnification agreement between the company and the individual director themselves).

<sup>52</sup> Cf. Subsections 3.4 and 4.3.

transferring Holder; provided further that all transferees who would not qualify individually for assignment of rights shall have a single attorney-in-fact for the purpose of exercising any rights, receiving notices, or taking any action under this Agreement. The terms and conditions of this Agreement inure to the benefit of and are binding upon the respective successors and permitted assignees of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and permitted assignees any rights, remedies, obligations or liabilities under or by reason of this Agreement, except as expressly provided herein.

6.2 Governing Law.<sup>53</sup> This Agreement shall be governed by the internal law of the [State of Delaware].<sup>54</sup>

6.3 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. Counterparts may be delivered via facsimile, electronic mail (including pdf) or other transmission method and any counterpart so delivered shall be deemed to have been duly and validly delivered and be valid and effective for all purposes.

6.4 Titles and Subtitles. The titles and subtitles used in this Agreement are for convenience only and are not to be considered in construing or interpreting this Agreement.

6.5 Notices. All notices and other communications given or made pursuant to this Agreement shall be in writing and shall be deemed effectively given upon the earlier of actual receipt or: (i) personal delivery to the party to be notified; (ii) when sent, if sent by electronic mail or facsimile during the recipient's normal business hours, and if not sent during normal business hours, then on the recipient's next business day; (iii) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid; or (iv) one (1) business day after the business day of deposit with a nationally recognized overnight courier, freight prepaid, specifying next-day delivery, with written verification of receipt. All communications shall be sent to the respective parties at their addresses as set forth on Schedule A [or Schedule B (as applicable)] hereto, or to the principal office of the Company and to the attention of the Chief Executive Officer, in the case of the Company, or to such email address, facsimile number, or address as subsequently modified by written notice given in accordance

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<sup>53</sup> After choosing the applicable law, the parties should determine whether such law imposes any particular requirements, such as special legends or other notices, in order to make restrictions on transfer of shares effective.

<sup>54</sup> Some practitioners may select Delaware law as it has historically been the richest source for corporation law precedent. Other practitioners will prefer to choose the (non-Delaware) jurisdiction in which they are admitted to practice, if for no other reason than not having to retain Delaware counsel in the event they are called upon to give an enforceability opinion. In *Abry Partners V v. F&W Acquisition LLC, Case No. C.A. 1756-N (Del Ch. Ct. 2/14/06)*, the Delaware Chancery Court stated that it would respect a Delaware choice of law provision so long as Delaware law has a material relationship to the transaction – which will very often be the case in venture financings (e.g., parties are Delaware corporation, LLPs, or LLCs). However, it should be noted that if an action is brought in a jurisdiction other than the state whose governing law has been selected, that jurisdiction will apply its own choice of law principles in deciding whether or not to give effect to the governing law selected by the parties. Further, under the internal affairs doctrine of the state whose law is chosen to govern the agreement, whether or not the parties so provide, the DGCL will apply to certain provisions (e.g., voting of shares of stock).

with this Subsection 6.5. If notice is given to the Company, a copy shall also be sent to [*Company counsel name and address*] and if notice is given to Stockholders, a copy shall also be given to [*Investor Counsel Name and Address*].

6.6 Amendments and Waivers.<sup>55</sup> Any term of this Agreement may be amended and the observance of any term of this Agreement may be waived (either generally or in a particular instance, and either retroactively or prospectively) only with the written consent of the Company and the holders of [a majority] of the Registrable Securities then outstanding; provided that the Company may in its sole discretion waive compliance with Subsection 2.12(c) (and the Company's failure to object promptly in writing after notification of a proposed assignment allegedly in violation of Subsection 2.12(c) shall be deemed to be a waiver); and provided further that any provision hereof may be waived by any waiving party on such party's own behalf, without the consent of any other party. Notwithstanding the foregoing, this Agreement may not be amended or terminated and the observance of any term hereof may not be waived with respect to any Investor without the written consent of such Investor, unless such amendment, termination, or waiver applies to all Investors in the same fashion (it being agreed that a waiver of the provisions of Section 4 with respect to a particular transaction shall be deemed to apply to all Investors in the same fashion if such waiver does so by its terms, notwithstanding the fact that certain Investors may nonetheless, by agreement with the Company, purchase securities in such transaction). [Further, this Agreement may not be amended, and no provision hereof may be waived, in each case, in any way which would adversely affect the rights of the Key Holders hereunder in a manner disproportionate to any adverse effect such amendment or waiver would have on the rights of the Investors hereunder, without also the written consent of the holders of at least a majority of the Registrable Securities held by the Key Holders.] The Company shall give prompt notice of any amendment or termination hereof or waiver hereunder to any party hereto that did not consent in writing to such amendment, termination, or waiver. Any amendment, termination, or waiver effected in accordance with this Subsection 6.6 shall be binding on all parties hereto, regardless of whether any such party has consented thereto. No waivers of or exceptions to any term, condition, or provision of this Agreement, in any one or more instances, shall be deemed to be or construed as a further or continuing waiver of any such term, condition, or provision.

6.7 Severability. In case any one or more of the provisions contained in this Agreement is for any reason held to be invalid, illegal or unenforceable in any respect, such invalidity, illegality, or unenforceability shall not affect any other provision of this Agreement, and such invalid, illegal, or unenforceable provision shall be reformed and construed so that it will be valid, legal, and enforceable to the maximum extent permitted by law.

6.8 Aggregation of Stock.<sup>56</sup> All shares of Registrable Securities held or acquired by Affiliates shall be aggregated together for the purpose of determining the availability

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<sup>55</sup> The composition of the stockholder base should be reviewed carefully when setting amendment and waiver thresholds. If possible (especially if the holders of prior series of preferred stock will control the preferred stock as a whole), consider a separate vote by holders of each series. In general, rights as to each investor group should be separately waivable by that group.

<sup>56</sup> See also Subsection 6.1 for special aggregation rule applicable to transferees of Registrable Securities.

of any rights under this Agreement and such Affiliated persons may apportion such rights as among themselves in any manner they deem appropriate.

6.9 Additional Investors. Notwithstanding anything to the contrary contained herein, if the Company issues additional shares of the Company's [Series \_\_\_] Preferred Stock after the date hereof, [whether pursuant to the Purchase Agreement or otherwise,] any purchaser of such shares of [Series \_\_\_] Preferred Stock may become a party to this Agreement by executing and delivering an additional counterpart signature page to this Agreement, and thereafter shall be deemed an "Investor" for all purposes hereunder. No action or consent by the Investors shall be required for such joinder to this Agreement by such additional Investor, so long as such additional Investor has agreed in writing to be bound by all of the obligations as an "Investor" hereunder.

6.10 Entire Agreement. This Agreement (including any Schedules and Exhibits hereto) constitutes the full and entire understanding and agreement among the parties with respect to the subject matter hereof, and any other written or oral agreement relating to the subject matter hereof existing between the parties is expressly canceled. [Upon the effectiveness of this Agreement, the Prior Agreement shall be deemed amended and restated and superseded and replaced in its entirety by this Agreement, and shall be of no further force or effect.]<sup>57</sup>

6.11 Dispute Resolution.<sup>58</sup> The parties (a) hereby irrevocably and unconditionally submit to the jurisdiction of the state courts of [state] and to the jurisdiction of the United States District Court for the District of [judicial district] for the purpose of any suit, action or other proceeding arising out of or based upon this Agreement, (b) agree not to commence any suit, action or other proceeding arising out of or based upon this Agreement except in the state courts of [state] or the United States District Court for the District of [judicial district], and (c) hereby waive, and agree not to assert, by way of motion, as a defense, or otherwise, in any such suit, action or proceeding, any claim that it is not subject personally to the jurisdiction of the above-named courts, that its property is exempt or immune from attachment or execution, that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that this Agreement or the subject matter hereof may not be enforced in or by such court.

WAIVER OF JURY TRIAL: EACH PARTY HEREBY WAIVES ITS RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT, THE OTHER TRANSACTION DOCUMENTS, THE SECURITIES OR

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<sup>57</sup> Alternatively, if the Prior Agreement is terminated rather than amended and restated, "the Prior Agreement shall terminate and be of no further force and effect and shall be superseded and replaced in its entirety by this Agreement."

<sup>58</sup> In the prior version of the NVCA Model Documents it was noted that in 2009 Delaware enacted legislation permitting confidential arbitration of disputes before a sitting Delaware Chancery Court Chancellor so long as 1) at least one party is a Delaware business entity or has its principal place of business in Delaware and 2) there is at least \$1 million in controversy. However, in August 2012 the U.S. District Court for the District of Delaware held in *Delaware Coalition for Open Government v. Strine* (D. Del. Aug. 30, 2012) that such confidential arbitration violates the First Amendment's right of access to civil trials. For so long as this decision stands (the State of Delaware reportedly plans to appeal), it seems imprudent to include a provision stipulating that disputes are to be arbitrated in the Delaware Court of Chancery.

THE SUBJECT MATTER HEREOF OR THEREOF. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL-ENCOMPASSING OF ANY AND ALL DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS TRANSACTION, INCLUDING, WITHOUT LIMITATION, CONTRACT CLAIMS, TORT CLAIMS (INCLUDING NEGLIGENCE), BREACH OF DUTY CLAIMS, AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. THIS SECTION HAS BEEN FULLY DISCUSSED BY EACH OF THE PARTIES HERETO AND THESE PROVISIONS WILL NOT BE SUBJECT TO ANY EXCEPTIONS. EACH PARTY HERETO HEREBY FURTHER WARRANTS AND REPRESENTS THAT SUCH PARTY HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT SUCH PARTY KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL.

*[Alternative:* Any unresolved controversy or claim arising out of or relating to this Agreement, except as (i) otherwise provided in this Agreement, or (ii) any such controversies or claims arising out of either party's intellectual property rights for which a provisional remedy or equitable relief is sought, shall be submitted to arbitration by one arbitrator mutually agreed upon by the parties, and if no agreement can be reached within thirty (30) days after names of potential arbitrators have been proposed by the American Arbitration Association (the "AAA"), then by one arbitrator having reasonable experience in corporate finance transactions of the type provided for in this Agreement and who is chosen by the AAA. The arbitration shall take place in [location], in accordance with the AAA rules then in effect, and judgment upon any award rendered in such arbitration will be binding and may be entered in any court having jurisdiction thereof. There shall be limited discovery prior to the arbitration hearing as follows: (a) exchange of witness lists and copies of documentary evidence and documents relating to or arising out of the issues to be arbitrated, (b) depositions of all party witnesses and (c) such other depositions as may be allowed by the arbitrators upon a showing of good cause. Depositions shall be conducted in accordance with the [state] Code of Civil Procedure, the arbitrator shall be required to provide in writing to the parties the basis for the award or order of such arbitrator, and a court reporter shall record all hearings, with such record constituting the official transcript of such proceedings.

[Each party will bear its own costs in respect of any disputes arising under this Agreement.] [The prevailing party shall be entitled to reasonable attorney's fees, costs, and necessary disbursements in addition to any other relief to which such party may be entitled.] Each of the parties to this Agreement consents to personal jurisdiction for any equitable action sought in the U.S. District Court for the District of [\_\_\_\_\_] or any court of the [State][Commonwealth] of [state] having subject matter jurisdiction.]

6.12 Delays or Omissions. No delay or omission to exercise any right, power, or remedy accruing to any party under this Agreement, upon any breach or default of any other party under this Agreement, shall impair any such right, power, or remedy of such nonbreaching or nondefaulting party, nor shall it be construed to be a waiver of or acquiescence to any such breach or default, or to any similar breach or default thereafter occurring, nor shall any waiver of any single breach or default be deemed a waiver of any other breach or default theretofore or thereafter occurring. All remedies, whether under this Agreement or by law or otherwise afforded to any party, shall be cumulative and not alternative.

6.13 [Acknowledgment]. The Company acknowledges that the Investors are in the business of venture capital investing and therefore review the business plans and related proprietary information of many enterprises, including enterprises which may have products or services which compete directly or indirectly with those of the Company. Nothing in this Agreement shall preclude or in any way restrict the Investors from investing or participating in any particular enterprise whether or not such enterprise has products or services which compete with those of the Company.]

[Remainder of Page Intentionally Left Blank]

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first written above.

*[Insert Company Name]*

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

KEY HOLDERS:

Signature: \_\_\_\_\_

Name: \_\_\_\_\_

INVESTORS:

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

## **SCHEDULE A**

### **Investors**

*[Investor Name  
Address  
Phone Number  
Fax Number  
Email]*

*[Investor Name  
Address  
Phone Number  
Fax Number  
Email]*

*[Investor Name  
Address  
Phone Number  
Fax Number  
Email]*



**[SCHEDULE B**

**Key Holders]**

*[Key Holder Name  
Address  
Phone Number  
Fax Number  
Email]*

*[Key Holder Name  
Address  
Phone Number  
Fax Number  
Email]*

*[Key Holder Name  
Address  
Phone Number  
Fax Number  
Email]*

**[EXHIBIT A**

**Form Of Noncompetition and Nonsolicitation Agreement]**

**[AMENDED AND RESTATED]  
VOTING AGREEMENT**

## TABLE OF CONTENTS

*Note to Drafter: Section headings have been formatted to automatically populate the Table of Contents. However, when editing this document for your own use, the page numbers may change. In order to reflect the correct page numbers in the Table of Contents, you must “update page numbers” to the Table of Contents by (1) right-clicking anywhere in the Table of Contents and (2) choose “update field,” then “update page numbers only.” If you add or delete section headings, follow step (1) and (2) above and choose “update entire table.”*

	<u>Page</u>
1. Voting Provisions Regarding Board of Directors .....	2
1.1 Size of the Board .....	2
1.2 Board Composition.....	2
1.3 Failure to Designate a Board Member.....	4
1.4 Removal of Board Members .....	4
1.5 No Liability for Election of Recommended Directors .....	5
2. Vote to Increase Authorized Common Stock .....	5
3. [Drag-Along Right.....	5
3.1 Definitions .....	5
3.2 Actions to be Taken.....	6
3.3 Exceptions .....	7
3.4 Restrictions on Sales of Control of the Company .....	9
4. Remedies.....	10
4.1 Covenants of the Company .....	10
4.2 [Irrevocable Proxy and Power of Attorney .....	10
4.3 Specific Enforcement .....	11
4.4 Remedies Cumulative.....	11
5. Term.....	11
6. Miscellaneous .....	11
6.1 Additional Parties .....	11
6.2 Transfers .....	12
6.3 Successors and Assigns .....	12
6.4 Governing Law .....	12
6.5 Counterparts .....	13
6.6 Titles and Subtitles .....	13
6.7 Notices.....	13
6.8 Consent Required to Amend, Terminate or Waive .....	13
6.9 Delays or Omissions.....	14
6.10 Severability.....	14
6.11 Entire Agreement .....	14
6.12 Legend on Share Certificates.....	15
6.13 Stock Splits, Stock Dividends, etc.....	15

6.14	Manner of Voting .....	15
6.15	Further Assurances .....	15
6.16	Dispute Resolution .....	16
6.17	[Costs of Enforcement.....	17
6.18	Aggregation of Stock.....	17
6.19	[Spousal Consent.....	18

- Schedule A - Investors
- Schedule B - Key Holders
- Exhibit A - Adoption Agreement
- [Exhibit B - Consent of Spouse]

ADDENDUM TO VOTING AGREEMENT: SAMPLE SALE RIGHTS

## [AMENDED AND RESTATED] VOTING AGREEMENT

THIS [AMENDED AND RESTATED] VOTING AGREEMENT is made and entered into as of this [ ] day of [ ], 20[ ], by and among [ ], a [Delaware] corporation (the “**Company**”), each holder of the Company’s Series A Preferred Stock, [\$. ] par value per share (“**Series A Preferred Stock**”) [and Series [ ] Preferred Stock] (referred to herein [collectively with the Series A Preferred Stock,] as the “**Preferred Stock**”) listed on Schedule A (together with any subsequent investors, or transferees, who become parties hereto as “**Investors**” pursuant to Subsection[s 6.1(a) or 6.2 below, the “**Investors**”) and those certain stockholders of the Company [and holders of options to acquire shares of the capital stock of the Company] listed on Schedule B (together with any subsequent stockholders [or option holders], or any transferees, who become parties hereto as “**Key Holders**” pursuant to Subsection[s 6.1(b) or] 6.2 below, the “**Key Holders**”<sup>1</sup>, and together collectively with the Investors, the “**Stockholders**”).

### RECITALS

[*Alternative 1:*<sup>2</sup> A. Concurrently with the execution of this Agreement, the Company and the Investors are entering into a Series A Preferred Stock Purchase Agreement (the “**Purchase Agreement**”) providing for the sale of shares of the Company’s Series A Preferred Stock, and in connection with that agreement the parties desire to provide the Investors with the right, among other rights, to designate the election of certain members of the board of directors of the Company (the “**Board**”) in accordance with the terms of this Agreement.<sup>3</sup>]

[*Alternative 2:*<sup>4</sup> A. Concurrently with the execution of this Agreement, the Company and the certain of the Investors are entering into a Series [B] Preferred Stock Purchase Agreement (the “**Purchase Agreement**”) providing for the sale of shares of the Company’s Series B Preferred Stock (“**Series B Preferred Stock**”). Certain of the Investors (the “**Existing Investors**”) and the Key Holders are parties to the Voting Agreement dated [ ] by and among the Company and the parties thereto (the “**Prior Agreement**”). The parties to the Prior Agreement desire to amend and restate that agreement to provide those Investors purchasing shares of the Company’s Series [B] Preferred Stock with the right, among other rights, to elect certain members of the board of directors of the Company (the “**Board**”) in accordance with the terms of this Agreement.]

B. The Amended and Restated Certificate of Incorporation of the Company (the “**Restated Certificate**”) provides that (a) the holders of record of the shares of the Company’s

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<sup>1</sup> In most cases investors will want the term “Key Holders” to include major common stock or option holders in addition to the individuals who actually founded the Company.

<sup>2</sup> The first alternative for the recital paragraph A assumes that the agreement concerns the sale of the Company’s first series of preferred stock.

<sup>3</sup> Section 706(a) of the California General Corporation Law (the “**CGCL**”) and Section 218(c) of the Delaware General Corporation Law (the “**DGCL**”) specifically allow voting agreements between stockholders, provided such agreements are in writing and signed by the parties thereto. The powers created by these sections are not limited to board matters.

<sup>4</sup> The second alternative for recital paragraph A assumes that a preexisting voting agreement is being superseded. It contemplates two or more different series of preferred stock. In the remainder of this Agreement, brackets indicate places where the drafter will have to take account of the existence of multiple series.

Series A Preferred Stock, exclusively and as a separate class, shall be entitled to elect [ ] directors of the Company (the “**Series A Directors**”) [and the holders of record of the shares of Series [B] Preferred Stock shall be entitled to elect [ ] directors of the Company]; [(b) the holders of record of the shares of common stock of the Company, [ ] par value (“**Common Stock**”), exclusively and as a separate class, shall be entitled to elect [ ] directors of the Company;] and (c) the holders of record of the shares of Common Stock and of any other class or series of voting stock (including Series A [and B] Preferred Stock), exclusively and voting together as a single class, shall be entitled to elect the balance of the total number of directors of the Company.<sup>5</sup>

[C. The parties also desire to enter into this Agreement to set forth their agreements and understandings with respect to how shares of the Company’s capital stock held by them will be voted on[, or tendered in connection with, an acquisition of the Company] [an increase in the number of shares of Common Stock required to provide for the conversion of the Company’s Preferred Stock.]]

NOW, THEREFORE, the parties agree as follows:

1. Voting Provisions Regarding Board of Directors.<sup>6</sup>

1.1 Size of the Board. Each Stockholder agrees to vote, or cause to be voted, all Shares (as defined below) owned by such Stockholder, or over which such Stockholder has voting control, from time to time and at all times, in whatever manner as shall be necessary to ensure that the size of the Board shall be set and remain at [five (5)] directors [and may be increased only with the written consent of Investors holding Preferred Stock representing at least [ ]% of the shares of Common Stock issuable upon conversion of the then outstanding shares of Preferred Stock.] For purposes of this Agreement, the term “Shares” shall mean and include any securities of the Company the holders of which are entitled to vote for members of the Board, including without limitation, all shares of Common Stock, Series A Preferred Stock[, and Series B Preferred Stock], by whatever name called, now owned or subsequently acquired by a Stockholder, however acquired, whether through stock splits, stock dividends, reclassifications, recapitalizations, similar events or otherwise.

1.2 Board Composition. Each Stockholder agrees to vote, or cause to be voted, all Shares owned by such Stockholder, or over which such Stockholder has voting control, from time to time and at all times, in whatever manner as shall be necessary to ensure that at each annual or special meeting of stockholders at which an election of directors is held or pursu-

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<sup>5</sup> Appropriate modifications to this form will be required to reflect the actual series of preferred stock outstanding and the relative rights of such series.

<sup>6</sup> Careful consideration should be given to ensure that the voting agreement does not contradict class or series votes created by the Certificate of Incorporation. In particular, if the Certificate of Incorporation provides for the creation of an additional series (e.g., Series A-1) to effectuate “pay-to-play” provisions, care should be taken to ensure that such shares are also included in the appropriate places in this Agreement. In addition, especially for California corporations, consider the effects that cumulative voting may have on the class and series votes created by the Certificate of Incorporation.

ant to any written consent of the stockholders, the following persons shall be elected to the Board:<sup>7</sup>

(a) One person designated by [*Name of Investor*] (the “**Name of Investor Designee**”), which individual shall initially be [\_\_\_\_\_], for so long as such Stockholders and their Affiliates continue to own beneficially at least [\_\_\_\_\_] shares of Common Stock of the Company (including shares of Common Stock issued or issuable upon conversion of Series A Preferred Stock), which number is subject to appropriate adjustment for all stock splits, dividends, combinations, recapitalizations and the like.

(b) One person designated by [*Name of 2d Investor*] (the “**Name of 2d Investor Designee**”), which individual shall initially be [\_\_\_\_\_] for so long as such Stockholders and their Affiliates continue to own beneficially at least [\_\_\_\_\_] shares of Common Stock of the Company (including shares of Common Stock issued or issuable upon conversion of Series A Preferred Stock), which number is subject to appropriate adjustment for all stock splits, dividends, combinations, recapitalizations and the like.

(c) [*Alternative 1*: For so long as the Key Holders [who are then providing services to the Company as officers, employees or consultants] hold at least [\_\_\_\_\_] shares of Common Stock (as adjusted for any stock splits, stock dividends, recapitalizations or the like), one individual designated by the holders of a majority of the Shares of Common Stock [held by the Key Holders], which individual shall initially be [\_\_\_\_\_];

[*Alternative 2*: [*name of Key Holder*], for so long as [*name of Key Holder*] [remains an [officer] [employee] of the Company] [holds at least [\_\_\_\_\_] Shares (as adjusted for stock splits, stock dividends, recapitalizations or the like)] [holds at least [\_\_\_\_\_] % of the outstanding capital stock of the Company on an as-converted-to-Common Stock basis] [, except that if [*name of Key Holder*] declines or is unable to serve, his or her successor shall be designated by [*name of alternate Key Holder*] [the holders of a majority of the shares of Common Stock of the Company];<sup>8</sup>

(d) The Company’s Chief Executive Officer, who shall initially be [\_\_\_\_\_] (the “**CEO Director**”), provided that if for any reason the CEO Director shall cease to serve as the Chief Executive Officer of the Company, each of the Stockholders shall promptly vote their respective Shares (i) to remove the former Chief Executive Officer from the Board if such person has not resigned as a member of the Board and (ii) to elect such person’s replacement as Chief Executive Officer of the Company as the new CEO Director; and

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<sup>7</sup> The number of permutations of board composition are almost limitless. Some of the more common requirements are set forth in Section 1.2.

<sup>8</sup> Careful consideration should be given whenever an individual is named to serve as a director who may have the ability to continue to serve at his or her pleasure. Alternative 1 provides that a founder director shall be elected by the majority of the Key Holders’ shares or the shares of common stock, depending upon which alternative is selected, but in fact the designated founder may have sufficient shares of stock to control that vote. Alternative 2 has a variety of choices: the first ties the Board seat to continued status as an officer or employee, which may be within the control of the majority of the board of directors; the other alternatives tie the right to designate a director only to continued minimum holdings of stock.



(e) One individual not otherwise an Affiliate (as defined below) of the Company or of any Investor who is [mutually acceptable to (i) the holders of a majority of the Shares held by the Key Holders who are then providing services to the Company as officers, employees or consultants and (ii) the holders of a majority of the Shares held by the Investors][mutually acceptable to the other members of the Board]; and

To the extent that any of clauses (a) through (d) above shall not be applicable, any member of the Board who would otherwise have been designated in accordance with the terms thereof shall instead be voted upon by all the stockholders of the Company entitled to vote thereon in accordance with, and pursuant to, the Company's Restated Certificate.

For purposes of this Agreement, an individual, firm, corporation, partnership, association, limited liability company, trust or any other entity (collectively, a "**Person**") shall be deemed an "**Affiliate**" of another Person who, directly or indirectly, controls, is controlled by or is under common control with such Person, including, without limitation, any general partner, managing member, officer or director of such Person or any venture capital fund now or hereafter existing that is controlled by one or more general partners or managing members of, or shares the same management company with, such Person.

1.3 Failure to Designate a Board Member. In the absence of any designation from the Persons or groups with the right to designate a director as specified above, the director previously designated by them and then serving shall be reelected if still eligible to serve as provided herein.

1.4 Removal of Board Members. Each Stockholder also agrees to vote, or cause to be voted, all Shares owned by such Stockholder, or over which such Stockholder has voting control, from time to time and at all times, in whatever manner as shall be necessary to ensure that:

(a) no director elected pursuant to Subsections 1.3 or 1.4 of this Agreement may be removed from office [other than for cause] unless (i) such removal is directed or approved by the affirmative vote of the Person, or of the holders of at least [*specify percentage*] of the shares of stock, entitled under Subsection 1.3 to designate that director<sup>9</sup> or (ii) the Person(s) originally entitled to designate or approve such director [or occupy such Board seat] pursuant to Subsection 1.3 is no longer so entitled to designate or approve such director [or occupy such Board seat];

(b) any vacancies created by the resignation, removal or death of a director elected pursuant to Subsections 1.3 or 1.4 shall be filled pursuant to the provisions of this Section 1;<sup>10</sup> and

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<sup>9</sup> Alternatively, the agreement can enumerate the identity of each group whose consent is necessary to remove each director, but care should be given to ensure that the consent requirements conform to the exact subsets entitled to designate directors, e.g., "the holders of a majority of the Shares held by the Key Holders who are then providing services to the Company as officers, employees or consultants."

<sup>10</sup> For flexibility reasons it may be useful to permit the Board to fill the vacancy in addition to the right of the stockholders to do so. If so, the drafter should provide that the person to fill the vacancy must be (continued...)

(c) upon the request of any party entitled to designate a director as provided in Subsection 1.2(a) or 1.2(b) to remove such director, such director shall be removed.

All Stockholders agree to execute any written consents required to perform the obligations of this Agreement, and the Company agrees at the request of any party entitled to designate directors to call a special meeting of stockholders for the purpose of electing directors. [So long as the stockholders of the Company are entitled to cumulative voting, if less than the entire Board is to be removed, no director may be removed without cause if the votes cast against his or her removal would be sufficient to elect such director if then cumulatively voted at an election of the entire Board.]

1.5 No Liability for Election of Recommended Directors. No Stockholder, nor any Affiliate of any Stockholder, shall have any liability as a result of designating a person for election as a director for any act or omission by such designated person in his or her capacity as a director of the Company, nor shall any Stockholder have any liability as a result of voting for any such designee in accordance with the provisions of this Agreement.

2. Vote to Increase Authorized Common Stock. Each Stockholder agrees to vote or cause to be voted all Shares owned by such Stockholder, or over which such Stockholder has voting control, from time to time and at all times, in whatever manner as shall be necessary to increase the number of authorized shares of Common Stock from time to time to ensure that there will be sufficient shares of Common Stock available for conversion of all of the shares of Preferred Stock outstanding at any given time.

3. [Drag-Along Right].<sup>11</sup>

3.1 Definitions. A “**Sale of the Company**” shall mean either: (a) a transaction or series of related transactions in which a Person, or a group of related Persons, acquires from stockholders of the Company shares representing more than fifty percent (50%) of the out-

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approved by the Person who has the right to nominate that director pursuant to this Voting Agreement, and should take care that the provision is in accord with the Certificate of Incorporation, the bylaws and the applicable corporations code. See Section 223 of the DGCL or Section 305 of the CGCL.

<sup>11</sup> A drag-along right gives a defined group of stockholders the right to deliver all (or most) of the shares of a company without the need of effecting a freeze-out merger. The drafter should be mindful of the interplay between this provision and minority protections against changes in control that may be in the Certificate of Incorporation or the Investor Rights Agreement. Drag-along rights are less common than voting agreements regarding the composition of the board of directors, which are near universal. While drag-along agreements are not universal, it is arguable that a drag-along with a high voting percentage trigger is in the best interests of all parties. If so structured (and note that multiple voting constituencies can be defined as appropriate, such as all preferred together and/or each separate series, or all non-investor common and/or common held by existing management and employees), the objective of the drag-along is not to grant the investors the unilateral right to force a sale, but rather to ensure that all (or most) of the Company’s stockholders will approve a transaction approved by holders of a specified percentage of the Company’s stockholders. The voting rights of each group of constituents can be protected, while helping to prevent dissent by minority “cat and dog” stockholders. In this connection, it is important to note that many acquirors in M&A transactions will require the seller to deliver a certain percentage of the vote (or, stated differently, seek to reduce the risk of stockholders exercising appraisal rights). If such a “housekeeping” drag-along is included in the Voting Agreement, the Company should include similar provisions, and a waiver of dissenter’s rights, in its form of employee option agreements.

standing voting power of the Company (a “**Stock Sale**”); or (b) a transaction that qualifies as a “**Deemed Liquidation Event**” as defined in the Restated Certificate.

3.2 Actions to be Taken. In the event that (i) the holders of at least [*specify percentage*] of the shares of Common Stock then issued or issuable upon conversion of the shares of Series A Preferred Stock (the “**Selling Investors**”), [(ii)the Board of Directors ]<sup>12</sup> and [(iii) the holders of a majority of the then outstanding shares of Common Stock (other than those issued or issuable upon conversion of the shares of Series A Preferred Stock)] (collectively, the “**Electing Holders**”) approve a Sale of the Company in writing, specifying that this Section 3 shall apply to such transaction, then each Stockholder and the Company hereby agree:

(a) if such transaction requires stockholder approval, with respect to all Shares that such Stockholder owns or over which such Stockholder otherwise exercises voting power, to vote (in person, by proxy or by action by written consent, as applicable) all Shares in favor of, and adopt, such Sale of the Company (together with any related amendment to the Restated Certificate required in order to implement such Sale of the Company) and to vote in opposition to any and all other proposals that could [reasonably be expected to] delay or impair the ability of the Company to consummate such Sale of the Company;

(b) if such transaction is a Stock Sale, to sell the same proportion of shares of capital stock of the Company beneficially held by such Stockholder as is being sold by the Selling Investors to the Person to whom the Selling Investors propose to sell their Shares, and, except as permitted in Subsection 3.3 below, on the same terms and conditions as the Selling Investors;

(c) to execute and deliver all related documentation and take such other action in support of the Sale of the Company as shall reasonably be requested by the Company or the Selling Investors in order to carry out the terms and provision of this Section 3, including without limitation executing and delivering instruments of conveyance and transfer, and any purchase agreement, merger agreement, indemnity agreement, escrow agreement, consent, waiver, governmental filing, share certificates duly endorsed for transfer (free and clear of impermissible liens, claims and encumbrances) and any similar or related documents;

(d) not to deposit, and to cause their Affiliates not to deposit, except as provided in this Agreement, any Shares of the Company owned by such party or Affiliate in a voting trust or subject any Shares to any arrangement or agreement with respect to the voting of such Shares, unless specifically requested to do so by the acquiror in connection with the Sale of the Company;

(e) to refrain from exercising any dissenters’ rights or rights of appraisal under applicable law at any time with respect to such Sale of the Company;

(f) if the consideration to be paid in exchange for the Shares pursuant to this Section 3 includes any securities and due receipt thereof by any Stockholder would

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<sup>12</sup> See footnote 29 (Addendum) for a discussion of why the drafters might elect not to include the Board as one of the parties necessary to trigger the drag-along, in light of the *Trados* decision.

require under applicable law (x) the registration or qualification of such securities or of any person as a broker or dealer or agent with respect to such securities or (y) the provision to any Stockholder of any information other than such information as a prudent issuer would generally furnish in an offering made solely to “accredited investors” as defined in Regulation D promulgated under the Securities Act of 1933, as amended, the Company may cause to be paid to any such Stockholder in lieu thereof, against surrender of the Shares which would have otherwise been sold by such Stockholder, an amount in cash equal to the fair value (as determined in good faith by the Company) of the securities which such Stockholder would otherwise receive as of the date of the issuance of such securities in exchange for the Shares; and

(g) in the event that the Selling Investors, in connection with such Sale of the Company, appoint a stockholder representative (the “**Stockholder Representative**”) with respect to matters affecting the Stockholders under the applicable definitive transaction agreements following consummation of such Sale of the Company, (x) to consent to (i) the appointment of such Stockholder Representative, (ii) the establishment of any applicable escrow, expense or similar fund in connection with any indemnification or similar obligations, and (iii) the payment of such Stockholder’s pro rata portion (from the applicable escrow or expense fund or otherwise) of any and all reasonable fees and expenses to such Stockholder Representative in connection with such Stockholder Representative’s services and duties in connection with such Sale of the Company and its related service as the representative of the Stockholders, and (y) not to assert any claim or commence any suit against the Stockholder Representative or any other Stockholder with respect to any action or inaction taken or failed to be taken by the Stockholder Representative in connection with its service as the Stockholder Representative, absent fraud or willful misconduct;

3.3 Exceptions.<sup>13</sup> Notwithstanding the foregoing, a Stockholder will not be required to comply with Subsection 3.2 above in connection with any proposed Sale of the Company (the “**Proposed Sale**”) unless:

(a) [any representations and warranties to be made by such Stockholder in connection with the Proposed Sale are limited to representations and warranties related to authority, ownership and the ability to convey title to such Shares, including but not limited to representations and warranties that (i) the Stockholder holds all right, title and interest in and to the Shares such Stockholder purports to hold, free and clear of all liens and encumbrances, (ii) the obligations of the Stockholder in connection with the transaction have been duly authorized, if applicable, (iii) the documents to be entered into by the Stockholder have been duly executed by the Stockholder and delivered to the acquirer and are enforceable against the Stockholder in accordance with their respective terms and (iv) neither the execution and delivery of documents to be entered into in connection with the transaction, nor the performance of the Stockholder’s obligations thereunder, will cause a breach or violation of the terms of any agreement, law or judgment, order or decree of any court or governmental agency;

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<sup>13</sup> Drafter should assess and make determination as to whether any or all of the listed conditions are appropriate for the relevant transaction. The non-bracketed conditions are the ones typically considered minimal to ensure that no one is treated unfairly as a result of invocation of the drag-along.

(b) the Stockholder shall not be liable for the inaccuracy of any representation or warranty made by any other Person in connection with the Proposed Sale, other than the Company (except to the extent that funds may be paid out of an escrow established to cover breach of representations, warranties and covenants of the Company as well as breach by any stockholder of any of identical representations, warranties and covenants provided by all stockholders);]

(c) the liability for indemnification, if any, of such Stockholder in the Proposed Sale and for the inaccuracy of any representations and warranties made by the Company or its Stockholders in connection with such Proposed Sale, is several and not joint with any other Person (except to the extent that funds may be paid out of an escrow established to cover breach of representations, warranties and covenants of the Company as well as breach by any stockholder of any of identical representations, warranties and covenants provided by all stockholders), and [subject to the provisions of the Restated Certificate related to the allocation of the escrow,]<sup>14</sup> is pro rata in proportion to, and does not exceed, the amount of consideration paid to such Stockholder in connection with such Proposed Sale;

(d) [liability shall be limited to such Stockholder's applicable share (determined based on the respective proceeds payable to each Stockholder in connection with such Proposed Sale in accordance with the provisions of the Restated Certificate) of a negotiated aggregate indemnification amount that applies equally to all Stockholders but that in no event exceeds the amount of consideration otherwise payable to such Stockholder in connection with such Proposed Sale, except with respect to claims related to fraud by such Stockholder, the liability for which need not be limited as to such Stockholder;]

(e) upon the consummation of the Proposed Sale, (i) each holder of each class or series of the Company's stock will receive the same form of consideration for their shares of such class or series as is received by other holders in respect of their shares of such same class or series of stock, (ii) each holder of a series of Preferred Stock will receive the same amount of consideration per share of such series of Preferred Stock as is received by other holders in respect of their shares of such same series, (iii) each holder of Common Stock will receive the same amount of consideration per share of Common Stock as is received by other holders in respect of their shares of Common Stock, and (iv) unless the holders of at least [*specify percentage*]<sup>15</sup> of the [Series A Preferred Stock] elect to receive a lesser amount by written notice given to the Company at least [ ] days prior to the effective date of any such Proposed Sale, the aggregate consideration receivable by all holders of the Preferred Stock and Common Stock shall be allocated among the holders of Preferred Stock and Common Stock on the basis of the relative liquidation preferences to which the holders of each respective series of Preferred Stock and the holders of Common Stock are entitled in a Deemed Liquidation Event (assuming for this purpose that the Proposed Sale is a Deemed Liquidation Event) in accordance

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<sup>14</sup> Include the bracketed language if you use the Allocation of Escrow provision (Section 2.3.4) of the Model Charter.

<sup>15</sup> The vote required to waive the treatment of a particular transaction as a Deemed Liquidation Event should comport with the vote that would be required to amend the Certificate of Incorporation to remove the transaction from the definition of "Deemed Liquidation Event" and the notice period in this sentence should be the same as the notice period in the Deemed Liquidation Event definition in the Certificate of Incorporation.

with the Company's Certificate of Incorporation in effect immediately prior to the Proposed Sale; *provided, however*, that, notwithstanding the foregoing, if the consideration to be paid in exchange for the Key Holder Shares or Investor Shares, as applicable, pursuant to this Subsection 3.3(e) includes any securities and due receipt thereof by any Key Holder or Investor would require under applicable law (x) the registration or qualification of such securities or of any person as a broker or dealer or agent with respect to such securities or (y) the provision to any Key Holder or Investor of any information other than such information as a prudent issuer would generally furnish in an offering made solely to "accredited investors" as defined in Regulation D promulgated under the Securities Act of 1933, as amended, the Company may cause to be paid to any such Key Holder or Investor in lieu thereof, against surrender of the Key Holder Shares or Investor Shares, as applicable, which would have otherwise been sold by such Key Holder or Investor, an amount in cash equal to the fair value (as determined in good faith by the Company) of the securities which such Key Holder or Investor would otherwise receive as of the date of the issuance of such securities in exchange for the Key Holder Shares or Investor Shares, as applicable; and

(f) [subject to clause (e) above, requiring the same form of consideration to be available to the holders of any single class or series of capital stock, if any holders of any capital stock of the Company are given an option as to the form and amount of consideration to be received as a result of the Proposed Sale, all holders of such capital stock will be given the same option; *provided, however*, that nothing in this Subsection 3.3(f) shall entitle any holder to receive any form of consideration that such holder would be ineligible to receive as a result of such holder's failure to satisfy any condition, requirement or limitation that is generally applicable to the Company's stockholders.

3.4 Restrictions on Sales of Control of the Company.<sup>16</sup> No Stockholder shall be a party to any Stock Sale unless all holders of Preferred Stock are allowed to participate in such transaction and the consideration received pursuant to such transaction is allocated among the parties thereto in the manner specified in the Company's Certificate of Incorporation in effect immediately prior to the Stock Sale (as if such transaction were a Deemed Liquidation Event), unless the holders of at least [*specify percentage*]<sup>17</sup> of the [Series A Preferred Stock] elect otherwise by written notice given to the Company at least [ ] days prior to the effective date of any such transaction or series of related transactions.]

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<sup>16</sup> The reason for this provision is that the "Deemed Liquidation Event" provisions of the Certificate of Incorporation cannot completely provide for the allocation of the purchase price paid in a sale of the Company if the sale is structured as a sale of stock by the Company's stockholders. This is because the Company may not be a party to the stock sale transaction and will not have the opportunity to ensure that the purchase price is allocated as dictated in the Certificate of Incorporation. This covenant is intended to prevent a group of controlling stockholders from circumventing the liquidation preference provision by structuring the sale as a stock sale if those stockholders do not otherwise have sufficient voting power to amend the definition of a "Deemed Liquidation Event." Co-sale provisions do not provide adequate protection for such a scenario either because (a) the co-sale right does not apply to the holders of preferred stock or (b), if co-sale rights do apply, the preferred stockholders exercising those rights might receive the same purchase price for their preferred stock as the selling common stockholders receive for this common stock, thereby losing the benefits of their liquidation preferences.

<sup>17</sup> See footnote 14.

[See ADDENDUM at end of this document with alternative “Sale Rights” provisions.]<sup>18</sup>

#### 4. Remedies.

4.1 Covenants of the Company. The Company agrees to use its best efforts, within the requirements of applicable law, to ensure that the rights granted under this Agreement are effective and that the parties enjoy the benefits of this Agreement. Such actions include, without limitation, the use of the Company’s best efforts to cause the nomination and election of the directors as provided in this Agreement.

4.2 [Irrevocable Proxy and Power of Attorney. Each party to this Agreement hereby constitutes and appoints as the proxies of the party and hereby grants a power of attorney to the President of the Company, and a designee of the Selling Investors, and each of them, with full power of substitution, with respect to the matters set forth herein, including without limitation, election of persons as members of the Board in accordance with Section 1 hereto, votes to increase authorized shares pursuant to Section 2 hereof and votes regarding any Sale of the Company pursuant to Section 3 hereof, and hereby authorizes each of them to represent and to vote, if and only if the party (i) fails to vote or (ii) attempts to vote (whether by proxy, in person or by written consent), in a manner which is inconsistent with the terms of this Agreement, all of such party’s Shares in favor of the election of persons as members of the Board determined pursuant to and in accordance with the terms and provisions of this Agreement or the increase of authorized shares or approval of any Sale of the Company pursuant to and in accordance with the terms and provisions of Sections 2 and 3, respectively, of this Agreement or to take any action necessary to effect Sections 2 and 3, respectively, of this Agreement. Each of the proxy and power of attorney granted pursuant to the immediately preceding sentence is given in consideration of the agreements and covenants of the Company and the parties in connection with the transactions contemplated by this Agreement and, as such, each is coupled with an interest and shall be irrevocable unless and until this Agreement terminates or expires pursuant to Section 5 hereof. Each party hereto hereby revokes any and all previous proxies or powers of attorney with respect to the Shares and shall not hereafter, unless and until this Agreement terminates or expires pursuant to Section 5 hereof, purport to grant any other proxy or power of attorney with respect to any of the Shares, deposit any of the Shares into a voting trust or enter into any agreement (other than this Agreement), arrangement or understanding with any person, directly or indirectly, to vote, grant any proxy or give instructions with respect to the voting of any of the Shares, in each case, with respect to any of the matters set forth herein.]<sup>19</sup>

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<sup>18</sup> See footnote 29 (Addendum).

<sup>19</sup> The proxy is intended to give the holder of voting rights a tool to force other stockholders to abide by the terms of this Agreement, even if the other stockholders do not agree or refuse to take the action the holder requires. Many stockholders will not give up the right to determine if the actions sought to be taken by the holder of voting rights are in accord with the terms of this Agreement. There may be a difference of opinion, for example, as to whether a proposed sale of the Company meets all conditions sufficient to fall with the definition of that term. Some practitioners believe the proxy would likely be used in situations when there is a dispute as to which actions are required, and that any exercise of the proxy could be hazardous to the holder of the right at that time. Accordingly, the proxy may not be very useful in the very situations when it might be invoked.

4.3 Specific Enforcement.<sup>20</sup> Each party acknowledges and agrees that each party hereto will be irreparably damaged in the event any of the provisions of this Agreement are not performed by the parties in accordance with their specific terms or are otherwise breached. Accordingly, it is agreed that each of the Company and the Stockholders shall be entitled to an injunction to prevent breaches of this Agreement, and to specific enforcement of this Agreement and its terms and provisions in any action instituted in any court of the United States or any state having subject matter jurisdiction.

4.4 Remedies Cumulative. All remedies, either under this Agreement or by law or otherwise afforded to any party, shall be cumulative and not alternative.

5. Term. This Agreement shall be effective as of the date hereof and shall continue in effect until and shall terminate upon the earliest to occur of (a) the consummation of the Company's first underwritten public offering of its Common Stock<sup>21</sup> (other than a registration statement relating either to the sale of securities to employees of the Company pursuant to its stock option, stock purchase or similar plan or an SEC Rule 145 transaction); (b) the consummation of a Sale of the Company and distribution of proceeds to or escrow for the benefit of the Stockholders in accordance with the Restated Certificate, provided that the provisions of Section 3 hereof will continue after the closing of any Sale of the Company to the extent necessary to enforce the provisions of Section 3 with respect to such Sale of the Company; (c) termination of this Agreement in accordance with Subsection 6.8 below [; and (d) \_\_\_\_\_, 20\_\_].

6. Miscellaneous.

6.1 Additional Parties.

(a) Notwithstanding anything to the contrary contained herein, if the Company issues additional shares of Series [ ] Preferred Stock after the date hereof, as a condition to the issuance of such shares the Company shall require that any purchaser of at least \_\_\_ shares of Series [ ] Preferred Stock become a party to this Agreement by executing and delivering (i) the Adoption Agreement attached to this Agreement as Exhibit A, or (ii) a counterpart signature page hereto agreeing to be bound by and subject to the terms of this Agreement as an Investor and Stockholder hereunder. In either event, each such person shall thereafter shall be deemed an Investor and Stockholder for all purposes under this Agreement.

(b) [In the event that after the date of this Agreement, the Company enters into an agreement with any Person to issue shares of capital stock to such Person (other than to a purchaser of Preferred Stock described in Subsection 6.1(a) above), [following which

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<sup>20</sup> Section 706(a) of the CGCL implies that specific performance is the preferred remedy in the case of voting agreements.

<sup>21</sup> Some voting agreements require a "qualified public offering" for the termination of the agreement. The blocking rights contained in the Certificate of Incorporation, however, should provide sufficient protection to the Investors. Retaining a "qualified public offering" requirement in the voting agreement creates possible blocking rights for individual investors not contemplated by the Certificate of Incorporation, and in any event gives rise to the need to obtain additional waivers and consents when one should be sufficient. The termination provision should conform to that in the Right of First Refusal and Co-sale Agreement and the Investors' Rights Agreement (other than the registration rights termination provision).



such Person shall hold Shares constituting one percent (1%) or more of the Company's then outstanding capital stock (treating for this purpose all shares of Common Stock issuable upon exercise of or conversion of outstanding options, warrants or convertible securities, as if exercised and/or converted or exchanged)], then, the Company shall cause such Person, as a condition precedent to entering into such agreement, to become a party to this Agreement by executing an Adoption Agreement in the form attached hereto as Exhibit A, agreeing to be bound by and subject to the terms of this Agreement as a Stockholder and thereafter such person shall be deemed a Stockholder for all purposes under this Agreement.]<sup>22</sup>

6.2 Transfers. Each transferee or assignee of any Shares subject to this Agreement shall continue to be subject to the terms hereof, and, as a condition precedent to the Company's recognizing such transfer, each transferee or assignee shall agree in writing to be subject to each of the terms of this Agreement by executing and delivering an Adoption Agreement substantially in the form attached hereto as Exhibit A. Upon the execution and delivery of an Adoption Agreement by any transferee, such transferee shall be deemed to be a party hereto as if such transferee were the transferor and such transferee's signature appeared on the signature pages of this Agreement and shall be deemed to be an Investor and Stockholder, or Key Holder and Stockholder, as applicable. The Company shall not permit the transfer of the Shares subject to this Agreement on its books or issue a new certificate representing any such Shares unless and until such transferee shall have complied with the terms of this Subsection 6.2. Each certificate representing the Shares subject to this Agreement if issued on or after the date of this Agreement shall be endorsed by the Company with the legend set forth in Subsection 6.12.

6.3 Successors and Assigns. The terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective successors and assigns of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and assigns any rights, remedies, obligations, or liabilities under or by reason of this Agreement, except as expressly provided in this Agreement.

6.4 Governing Law.<sup>23</sup> This Agreement shall be governed by the internal law of the [State of Delaware].<sup>24</sup>

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<sup>22</sup> This requirement cannot apply to any shares issued to an employee to which California Department of Corporations rules 260.140.41(l) or 260.140.42(i) apply. Voting rights must be unrestricted.

<sup>23</sup> After choosing the applicable law, the parties should determine whether such law imposes any particular requirements, such as special legends or other notices, in order to make restrictions on transfer of shares effective.

<sup>24</sup> Some practitioners may select Delaware law as it has historically been the richest source for corporation law precedent. Other practitioners will prefer to choose the (non-Delaware) jurisdiction in which they are admitted to practice, if for no other reason than not having to retain Delaware counsel in the event they are called upon to give an enforceability opinion. In *Abry Partners V v. F&W Acquisition LLC, Case No. C.A. 1756-N (Del Ch. Ct. 2/14/06)*, the Delaware Chancery Court stated that it would respect a Delaware choice of law provision so long as Delaware law has a material relationship to the transaction – which will very often be the case in venture financings (e.g., parties are Delaware corporation, LLPs, or LLCs). However, it should be noted that if an action is brought in a jurisdiction other than the state whose governing law has been selected, that jurisdiction will apply its own choice of law principles in deciding whether or not to give effect to the governing law selected by the parties. (continued...)

6.5 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. Counterparts may be delivered via facsimile, electronic mail (including pdf) or other transmission method and any counterpart so delivered shall be deemed to have been duly and validly delivered and be valid and effective for all purposes.

6.6 Titles and Subtitles. The titles and subtitles used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

6.7 Notices. All notices and other communications given or made pursuant to this Agreement shall be in writing and shall be deemed effectively given upon the earlier of actual receipt or: (a) personal delivery to the party to be notified, (b) when sent, if sent by electronic mail or facsimile during normal business hours of the recipient, and if not sent during normal business hours, then on the recipient's next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) business day after the business day of deposit with a nationally recognized overnight courier, freight prepaid, specifying next business day delivery, with written verification of receipt. All communications shall be sent to the respective parties at their address as set forth on Schedule A or Schedule B hereto, or to such email address, facsimile number or address as subsequently modified by written notice given in accordance with this Subsection 6.7. If notice is given to the Company, a copy shall also be sent to [*Company Counsel Name and Address*] and if notice is given to Stockholders, a copy shall also be given to [*Investor Counsel Name and Address*].

6.8 Consent Required to Amend, Terminate or Waive.<sup>25</sup> This Agreement may be amended or terminated and the observance of any term hereof may be waived (either generally or in a particular instance and either retroactively or prospectively) only by a written instrument executed by (a) the Company; (b) the Key Holders holding [*specify percentage*] of the Shares then held by the Key Holders [provided that such consent shall not be required if the Key Holders do not then own Shares representing at least [ ]% of the outstanding capital stock of the Company] [who are then providing services to the Company as officers, employees or consultants]; and (c) the holders of [*specify percentage*] of the shares of Common Stock issued or issuable upon conversion of the shares of Series A [and B] Preferred Stock held by the Investors (voting as a single class and on an as-converted basis). Notwithstanding the foregoing:

(a) this Agreement may not be amended or terminated and the observance of any term of this Agreement may not be waived with respect to any Investor or Key Holder without the written consent of such Investor or Key Holder unless such amendment, termination or waiver applies to all Investors or Key Holders, as the case may be, in the same fashion;

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Further, under the internal affairs doctrine of the state whose law is chosen to govern the agreement, whether or not the parties so provide, the DGCL will apply to certain provisions (e.g. voting of shares of stock).

<sup>25</sup> To the extent there are rights of individual parties to designate directors, care should be taken to ensure that the amendment section requires the vote of such party to amend the relevant sections of the document.

(b) the consent of the Key Holders shall not be required for any amendment or waiver if such amendment or waiver either (A) is not directly applicable to the rights of the Key Holders hereunder or (B) does not adversely affect the rights of the Key Holders in a manner that is different than the effect on the rights of the other parties hereto ;

(c) Schedules A hereto may be amended by the Company from time to time in accordance with Subsection 1.3 of the Purchase Agreement to add information regarding additional Purchasers (as defined in the Purchase Agreement) without the consent of the other parties hereto;

(d) any provision hereof may be waived by the waiving party on such party's own behalf, without the consent of any other party[; and

(e) Subsections 1.2(a) and 1.2(b) of this Agreement shall not be amended or waived without the written consent of [Investor 1] and [Investor 2], respectively, and Subsection 1.2(c) of this Agreement shall not be amended or waived without the written consent of [the Key Holders][the Key Holders who are at such time providing services to the Company as an officer, director, employee or consultant][the holders of [specify percentage] of shares of Common Stock].

The Company shall give prompt written notice of any amendment, termination or waiver hereunder to any party that did not consent in writing thereto. Any amendment, termination or waiver effected in accordance with this Subsection 6.8 shall be binding on each party and all of such party's successors and permitted assigns, whether or not any such party, successor or assignee entered into or approved such amendment, termination or waiver. For purposes of this Subsection 6.8, the requirement of a written instrument may be satisfied in the form of an action by written consent of the Stockholders circulated by the Company and executed by the Stockholder parties specified, whether or not such action by written consent makes explicit reference to the terms of this Agreement.

6.9 Delays or Omissions. No delay or omission to exercise any right, power or remedy accruing to any party under this Agreement, upon any breach or default of any other party under this Agreement, shall impair any such right, power or remedy of such non-breaching or non-defaulting party nor shall it be construed to be a waiver of any such breach or default, or an acquiescence therein, or of or in any similar breach or default thereafter occurring; nor shall any waiver of any single breach or default be deemed a waiver of any other breach or default previously or thereafter occurring. Any waiver, permit, consent or approval of any kind or character on the part of any party of any breach or default under this Agreement, or any waiver on the part of any party of any provisions or conditions of this Agreement, must be in writing and shall be effective only to the extent specifically set forth in such writing. All remedies, either under this Agreement or by law or otherwise afforded to any party, shall be cumulative and not alternative.

6.10 Severability. The invalidity or unenforceability of any provision hereof shall in no way affect the validity or enforceability of any other provision.

6.11 Entire Agreement. [Upon the effectiveness of this Agreement, the Prior Agreement shall be deemed amended and restated to read in its entirety as set forth in this

Agreement.]<sup>26</sup> This Agreement (including the Exhibits hereto), [and] the Restated Certificate [and the other Transaction Agreements (as defined in the Purchase Agreement)] constitute the full and entire understanding and agreement between the parties with respect to the subject matter hereof, and any other written or oral agreement relating to the subject matter hereof existing between the parties is expressly canceled.

6.12 Legend on Share Certificates. Each certificate representing any Shares issued after the date hereof shall be endorsed by the Company with a legend reading substantially as follows:

“THE SHARES EVIDENCED HEREBY ARE SUBJECT TO A VOTING AGREEMENT, AS MAY BE AMENDED FROM TIME TO TIME, (A COPY OF WHICH MAY BE OBTAINED UPON WRITTEN REQUEST FROM THE COMPANY), AND BY ACCEPTING ANY INTEREST IN SUCH SHARES THE PERSON ACCEPTING SUCH INTEREST SHALL BE DEEMED TO AGREE TO AND SHALL BECOME BOUND BY ALL THE PROVISIONS OF THAT VOTING AGREEMENT, INCLUDING CERTAIN RESTRICTIONS ON TRANSFER AND OWNERSHIP SET FORTH THEREIN.”

The Company, by its execution of this Agreement, agrees that it will cause the certificates evidencing the Shares issued after the date hereof to bear the legend required by this Subsection 6.12 of this Agreement, and it shall supply, free of charge, a copy of this Agreement to any holder of a certificate evidencing Shares upon written request from such holder to the Company at its principal office. The parties to this Agreement do hereby agree that the failure to cause the certificates evidencing the Shares to bear the legend required by this Subsection 6.12 herein and/or the failure of the Company to supply, free of charge, a copy of this Agreement as provided hereunder shall not affect the validity or enforcement of this Agreement.

6.13 Stock Splits, Stock Dividends, etc. In the event of any issuance of Shares of the Company’s voting securities hereafter to any of the Stockholders (including, without limitation, in connection with any stock split, stock dividend, recapitalization, reorganization, or the like), such Shares shall become subject to this Agreement and shall be endorsed with the legend set forth in Subsection 6.12.

6.14 Manner of Voting. The voting of Shares pursuant to this Agreement may be effected in person, by proxy, by written consent or in any other manner permitted by applicable law. For the avoidance of doubt, voting of the Shares pursuant to the Agreement need not make explicit reference to the terms of this Agreement.

6.15 Further Assurances. At any time or from time to time after the date hereof, the parties agree to cooperate with each other, and at the request of any other party, to execute and deliver any further instruments or documents and to take all such further action as the other party may reasonably request in order to evidence or effectuate the consummation of

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<sup>26</sup> The drafter should ensure that the relevant signatories to the current agreement have authority to terminate the prior agreement under the terms of the latter.

the transactions contemplated hereby and to otherwise carry out the intent of the parties hereunder.

6.16 Dispute Resolution.<sup>27</sup> The parties (a) hereby irrevocably and unconditionally submit to the jurisdiction of the state courts of [state] and to the jurisdiction of the United States District Court for the District of [judicial district] for the purpose of any suit, action or other proceeding arising out of or based upon this Agreement, (b) agree not to commence any suit, action or other proceeding arising out of or based upon this Agreement except in the state courts of [state] or the United States District Court for the District of [judicial district], and (c) hereby waive, and agree not to assert, by way of motion, as a defense, or otherwise, in any such suit, action or proceeding, any claim that it is not subject personally to the jurisdiction of the above-named courts, that its property is exempt or immune from attachment or execution, that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that this Agreement or the subject matter hereof may not be enforced in or by such court.

WAIVER OF JURY TRIAL: EACH PARTY HEREBY WAIVES ITS RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT, THE OTHER TRANSACTION DOCUMENTS, THE SECURITIES OR THE SUBJECT MATTER HEREOF OR THEREOF. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL-ENCOMPASSING OF ANY AND ALL DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS TRANSACTION, INCLUDING, WITHOUT LIMITATION, CONTRACT CLAIMS, TORT CLAIMS (INCLUDING NEGLIGENCE), BREACH OF DUTY CLAIMS, AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. THIS SECTION HAS BEEN FULLY DISCUSSED BY EACH OF THE PARTIES HERETO AND THESE PROVISIONS WILL NOT BE SUBJECT TO ANY EXCEPTIONS. EACH PARTY HERETO HEREBY FURTHER WARRANTS AND REPRESENTS THAT SUCH PARTY HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT SUCH PARTY KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL.

[*Alternative*: Any unresolved controversy or claim arising out of or relating to this Agreement, except as (i) otherwise provided in this Agreement, or (ii) any such controversies or claims arising out of either party's intellectual property rights for which a provisional remedy or equitable relief is sought, shall be submitted to arbitration by one arbitrator mutually agreed upon by the parties, and if no agreement can be reached within thirty (30) days after names of potential arbitrators have been proposed by the American Arbitration Association (the "AAA"), then by one arbitrator having reasonable experience in corporate finance transactions of the type

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<sup>27</sup> In the prior version of the NVCA Model Documents it was noted that in 2009 Delaware enacted legislation permitting confidential arbitration of disputes before a sitting Delaware Chancery Court Chancellor so long as 1) at least one party is a Delaware business entity or has its principal place of business in Delaware and 2) there is at least \$1 million in controversy. However, in August 2012 the U.S. District Court for the District of Delaware held in *Delaware Coalition for Open Government v. Strine* (D. Del. Aug. 30, 2012) that such confidential arbitration violates the First Amendment's right of access to civil trials. For so long as this decision stands (the State of Delaware reportedly plans to appeal), it seems imprudent to include a provision stipulating that disputes are to be arbitrated in the Delaware Court of Chancery.

provided for in this Agreement and who is chosen by the AAA. The arbitration shall take place in [location], in accordance with the AAA rules then in effect, and judgment upon any award rendered in such arbitration will be binding and may be entered in any court having jurisdiction thereof. There shall be limited discovery prior to the arbitration hearing as follows: (a) exchange of witness lists and copies of documentary evidence and documents relating to or arising out of the issues to be arbitrated, (b) depositions of all party witnesses and (c) such other depositions as may be allowed by the arbitrators upon a showing of good cause. Depositions shall be conducted in accordance with the [State] Code of Civil Procedure, the arbitrator shall be required to provide in writing to the parties the basis for the award or order of such arbitrator, and a court reporter shall record all hearings, with such record constituting the official transcript of such proceedings.

[Each party will bear its own costs in respect of any disputes arising under this Agreement.] [The prevailing party shall be entitled to reasonable attorney's fees, costs, and necessary disbursements in addition to any other relief to which such party may be entitled.] Each of the parties to this Agreement consents to personal jurisdiction for any equitable action sought in the U.S. District Court for the District of [\_\_\_\_\_] or any court of the [State][Commonwealth] of [state] having subject matter jurisdiction.]

6.17 Costs of Enforcement. If any party to this Agreement seeks to enforce its rights under this Agreement by legal proceedings, the non-prevailing party shall pay all costs and expenses incurred by the prevailing party, including, without limitation, all reasonable attorneys' fees.]

6.18 Aggregation of Stock. All Shares held or acquired by a Stockholder and/or its Affiliates shall be aggregated together for the purpose of determining the availability of any rights under this Agreement, and such Affiliated persons may apportion such rights as among themselves in any manner they deem appropriate.

6.19 [Spousal Consent. If any individual Stockholder is married on the date of this Agreement, such Stockholder's spouse shall execute and deliver to the Company a consent of spouse in the form of Exhibit B hereto ("**Consent of Spouse**"), effective on the date hereof. Notwithstanding the execution and delivery thereof, such consent shall not be deemed to confer or convey to the spouse any rights in such Stockholder's Shares that do not otherwise exist by operation of law or the agreement of the parties. If any individual Stockholder should marry or remarry subsequent to the date of this Agreement, such Stockholder shall within thirty (30) days thereafter obtain his/her new spouse's acknowledgement of and consent to the existence and binding effect of all restrictions contained in this Agreement by causing such spouse to execute and deliver a Consent of Spouse acknowledging the restrictions and obligations contained in this Agreement and agreeing and consenting to the same.]<sup>28</sup>

[Signature Page Follows]

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<sup>28</sup> To the extent any Key Holder or spouse thereof is a resident of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin, or the Commonwealth of Puerto Rico, a spousal consent may be needed. See Exhibit A. The necessity of such a consent should be researched carefully, since including this provision where the law is unclear may imply the existence of rights that would not otherwise exist.

IN WITNESS WHEREOF, the parties have executed this [Amended and Restated] Voting Agreement as of the date first written above.

*[Insert Company Name]*

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

KEY HOLDERS:

Signature: \_\_\_\_\_

Name: \_\_\_\_\_

INVESTORS:

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_



**SCHEDULE A**

**INVESTORS**

**Name and Address**

**Number of Shares Held**

**SCHEDULE B**

**KEY HOLDERS**

**Name and Address**

**Number of Shares Held**

**EXHIBIT A**

**ADOPTION AGREEMENT**

This Adoption Agreement (“**Adoption Agreement**”) is executed on \_\_\_\_\_, 20\_\_\_, by the undersigned (the “**Holder**”) pursuant to the terms of that certain Voting Agreement dated as of [\_\_\_\_\_, 20\_\_\_] (the “**Agreement**”), by and among the Company and certain of its Stockholders, as such Agreement may be amended or amended and restated hereafter. Capitalized terms used but not defined in this Adoption Agreement shall have the respective meanings ascribed to such terms in the Agreement. By the execution of this Adoption Agreement, the Holder agrees as follows.

1.1 Acknowledgement. Holder acknowledges that Holder is acquiring certain shares of the capital stock of the Company (the “**Stock**”)[ or options, warrants or other rights to purchase such Stock (the “**Options**”)], for one of the following reasons (Check the correct box):

- as a transferee of Shares from a party in such party’s capacity as an “Investor” bound by the Agreement, and after such transfer, Holder shall be considered an “Investor” and a “Stockholder” for all purposes of the Agreement.
- as a transferee of Shares from a party in such party’s capacity as a “Key Holder” bound by the Agreement, and after such transfer, Holder shall be considered a “Key Holder” and a “Stockholder” for all purposes of the Agreement.
- as a new Investor in accordance with Subsection 6.1(a) of the Agreement, in which case Holder will be an “Investor” and a “Stockholder” for all purposes of the Agreement.
- in accordance with Subsection 6.1(b) of the Agreement, as a new party who is not a new Investor, in which case Holder will be a “Stockholder” for all purposes of the Agreement.

1.2 Agreement. Holder hereby (a) agrees that the Stock [Options], and any other shares of capital stock or securities required by the Agreement to be bound thereby, shall be bound by and subject to the terms of the Agreement and (b) adopts the Agreement with the same force and effect as if Holder were originally a party thereto.

1.3 Notice. Any notice required or permitted by the Agreement shall be given to Holder at the address or facsimile number listed below Holder’s signature hereto.

**HOLDER:** \_\_\_\_\_

ACCEPTED AND AGREED:

By: \_\_\_\_\_  
Name and Title of Signatory

**[COMPANY]**

Address: \_\_\_\_\_

By: \_\_\_\_\_

\_\_\_\_\_

Title: \_\_\_\_\_

Facsimile Number: \_\_\_\_\_

**[EXHIBIT B**

**CONSENT OF SPOUSE]**

I, [\_\_\_\_\_], spouse of [\_\_\_\_\_], acknowledge that I have read the [Amended and Restated] Voting Agreement, dated as of [\_\_\_\_\_, 20\_\_\_\_], to which this Consent is attached as Exhibit B (the “**Agreement**”), and that I know the contents of the Agreement. I am aware that the Agreement contains provisions regarding the voting and transfer of shares of capital stock of the Company that my spouse may own, including any interest I might have therein.

I hereby agree that my interest, if any, in any shares of capital stock of the Company subject to the Agreement shall be irrevocably bound by the Agreement and further understand and agree that any community property interest I may have in such shares of capital stock of the Company shall be similarly bound by the Agreement.

I am aware that the legal, financial and related matters contained in the Agreement are complex and that I am free to seek independent professional guidance or counsel with respect to this Consent. I have either sought such guidance or counsel or determined after reviewing the Agreement carefully that I will waive such right.

Dated: \_\_\_\_\_

\_\_\_\_\_ *[Name of Key Holder’s Spouse, if any]*

## ADDENDUM TO VOTING AGREEMENT: SAMPLE SALE RIGHTS<sup>29</sup>

[Section \_\_. Sale Rights.

\_\_. Initiation of Sale Process. Upon written notice to the Company from the Electing Holders, the Company shall initiate a process (the “Sale Process”), in accordance with this Section \_\_, intended to result in a Sale of the Company. Such written notice shall include a designation of one individual (the “**Holder Representative**”) to act on behalf of the Electing Holders and to exercise the authority granted to the Holder Representative pursuant to Section \_\_ below. Each of the Stockholders and the Company agree to use his, her or its commercially reasonable efforts, in consultation with the Financial Advisor (as defined below) and Deal Counsel (as defined below), to facilitate a Sale of the Company. In furtherance of the foregoing, upon receipt of the notice described above the Company shall, and shall cause its officers, employees, consultants, counsel and advisors to take the actions set forth in Section \_\_ below.

\_\_.1. Specific Obligations.

\_\_.1.1 Advisors. The Company shall engage an investment bank (the “**Financial Advisor**”) and a law firm (the “**Deal Counsel**”) reasonably satisfactory to the Holder Representative (which may be the Company’s existing investment bank and law firm) to assist with the Sale Process. The Financial Advisor and Deal Counsel, as well as any other advisors engaged pursuant to this Section \_\_ (i), shall represent the Company, and only the Company, in the sale process, and the costs, fees and expenses of such advisors shall be paid by the Company pursuant to the terms of engagement letters that are approved by the Holder Representative (such

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<sup>29</sup> The “Sale Rights” provisions in this Addendum have been drafted in response to the Delaware Chancery Court’s ruling in *In re Trados Inc. S’holder Litigation, Case No. C.A. 1512-CC (Del. Ch. Ct. 7/24/09)*. In that case, where a company was sold for less than the preferred stock liquidation preferences (leaving nothing for the common stockholders upon the sale), the Court concluded *that, in circumstances where the interests of the common stockholders may diverge from those of the preferred, a director can breach his or her duty by approving a sale which could be viewed as improperly favoring the interests of the preferred over those of the common stockholders.*

The plaintiffs in that case argued that the company was on an upswing, and that if the company had been sold at a later date, there may have been proceeds for common stockholders. This ruling may expose directors to potential liability where they vote in favor of a sale at a price below the liquidation preferences that results in no proceeds for common stockholders. Accordingly, the “Sale Rights” provisions are designed to insulate the Board from a *Trados*-type claim. In particular, since this section provides for redemption rights additional to any that may be included in the Certificate of Incorporation, selling the company may be the only means by which the Board is able to honor this contractual “put” obligation.

Investors who are bridging a company to a sale may want to consider amending the Voting Agreement to include provisions such as those found in this Addendum, particularly where 1) there are no disinterested directors to vote on the sale transaction and 2) the transaction is anticipated to result in proceeds below the liquidation preferences.

The company will need to consult with its accountants with respect to the accounting treatment of the “put right” provided for here; it is the drafters’ hope that it is attenuated enough that the company’s accountants will not require it to be reflected as debt on the company’s balance sheet.

Finally, note that this provision is intended to work in conjunction with the drag-along provisions, and is not in lieu of them. It is the “Electing Holders” who trigger the provisions of this “Sale Rights” section – the same group that triggers the drag-along provisions in Section 3. These “Sale Rights” are not intended to give the Electing Holders (however defined) additional substantive rights, but rather to assist them in effecting the transaction they have approved.

approval not to be unreasonably withheld, conditioned or delayed). None of the Financial Advisor, Deal Counsel or any other advisor selected in accordance with this Section \_\_ (i) shall be terminated by the Company without the written consent of the Holder Representative.

.1.2 Cooperation With Sale Process. Without limiting the generality of the provisions of Section \_\_.1, at the request of the Holder Representative, the Company shall, and shall cause its employees, officers, consultants, counsel and advisors to:

(i) Assist the Financial Advisor in creating a list of potential acquirers;

(ii) Set up and maintain a virtual or actual data room (as elected by the Holder Representative) containing due diligence materials customarily provided in connection with transactions of the nature of a Sale of the Company, along with any other due diligence materials requested by the Holder Representative or reasonably requested by any potential acquirer;

(iii) Execute customary non-disclosure agreements with potential acquirers;

(iv) Provide incentive compensation to members of the Company's management, and in an amount and form, all as determined by the Holder Representative to be necessary or helpful to the successful consummation of the Sale of the Company;

(v) Prepare, or assist the Financial Advisor with the preparation of, any marketing, financial or other materials deemed by the Holder Representative or the Financial Advisor to be necessary or helpful in connection with a Sale of the Company;

(vi) Attend and participate in any meetings, conference calls or presentations regarding the Company and its business with potential acquirers;

(vii) Execute a letter of intent or term sheet on terms reasonably acceptable to the Holder Representative with one or more potential acquirers;

(viii) Subject to Section \_\_.3, execute and perform the Company's obligations contained in such definitive agreements relating to a Sale of the Company as are negotiated by the Holder Representative and the potential acquirer; and

(ix) Communicate regularly and promptly with each of the Financial Advisor and Deal Counsel regarding the Sale Process.

.1.3 Approval of the Terms and Conditions of a Proposed Sale of the Company; Failure to Approve a Sale of the Company.

(a) The Company shall cause its management, together with the Financial Advisor and Deal Counsel, to deliver regular updates to its Board regarding material developments in the Sale Process and summarizing the status of the negotiation of the terms and conditions of the Sale of the Company. The Company shall, upon request of the Holder Representative, either call a meeting of its Board or seek the written consent of the Board

approving the Sale of the Company and the entering into of the definitive agreements relating thereto.

(b) In the event that the Board approval described in (i) above has not been obtained within the time period requested by the Holder Representative (such time period not to be less than three (3) business days), the Electing Holders shall have the right by written notice (the “**Redemption Notice**”) to require the Company to redeem all of the then outstanding shares of capital stock held by the Electing Holders at a price equal to the amount of proceeds that would have been paid in respect of their shares of capital stock were the Sale of the Company consummated (or, in the case of a Sale of the Company that is structured as a sale of all or substantially all of the Company’s assets, the amount of proceeds that would have been paid in respect of their investment in the Company had all proceeds from the proposed Sale of the Company been distributed in a Deemed Liquidation Event (a “**Preferred Redemption**”). The Company and each Investor shall be obligated to effect the Preferred Redemption within ten (10) days of the delivery of the Redemption Notice.

#### \_\_1.4 Appointment and Authority of Holder Representative.

(a) The Stockholders have agreed that it is desirable to designate a representative to act on behalf of the Stockholders for the purposes described in this Section \_\_\_\_. The Holder Representative shall be selected by the Electing Holders and shall serve as the agent and representative of each Stockholder with respect to the matters set forth in this Agreement.

(b) The Holder Representative shall have full power and authority to take all actions under this Agreement that are to be taken by the Holder Representative. The Holder Representative shall take any and all actions which it believes are necessary or appropriate under this Agreement, including giving and receiving any notice or instruction permitted or required under this Agreement by the Holder Representative, interpreting all of the terms and provisions of this Agreement, consenting to any actions on behalf of the Stockholders in connection with a Sale of the Company (except with respect to any approvals of the final terms and conditions of such Sale of the Company by the Investors in their capacities as such), conducting negotiations with any potential acquirer and its agents regarding such Sale of the Company, dealing with the Company under this Agreement, taking any and all other actions specified in or contemplated by this Agreement, and engaging counsel, accountants or other representatives to represent the Electing Holders in connection with the foregoing matters. Without limiting the generality of the foregoing, the Holder Representative shall have the full power and authority to interpret all the terms and provisions of this Agreement and amendment hereof or thereof in its capacity as Holder Representative.

(c) The Holder Representative shall be indemnified for and shall be held harmless by the Investors against any Losses incurred by the Holder Representative or any of its Affiliates and any of their respective partners, directors, officers, employees, agents, stockholders, consultants, attorneys, accountants, advisors, brokers, representatives or controlling persons, in each case relating to the Holder Representative’s conduct as Holder Representative, other than damages or losses resulting from the Holder Representative’s gross negligence or willful misconduct in connection with its performance under this Agreement. This indemnification shall survive the termination of this Agreement. The Holder Representative may, in all questions arising under this Agreement, rely on the advice of counsel and for

anything done, omitted or suffered in good faith by the Holder Representative in accordance with such advice, the Holder Representative shall not be liable to the Stockholders. In no event shall the Holder Representative be liable hereunder or in connection herewith to the Stockholders for any indirect, punitive, special or consequential damages.

(d) Any action taken by the Holder Representative pursuant to the authority granted in this Section shall be effective and absolutely binding as the action of the Stockholders under this Agreement.

(e) The Company shall be entitled to rely on the actions and determinations of the Holder Representative, and shall have no liability whatsoever with respect to any action or omission of them taken in reliance on the actions or omissions of the Holder Representative.



**[AMENDED AND RESTATED]  
RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT**

## TABLE OF CONTENTS

*Note to Drafter: Section headings have been formatted to automatically populate the Table of Contents. However, when editing this document for your own use, the page numbers may change. In order to reflect the correct page numbers in the Table of Contents, you must “update page numbers” to the Table of Contents by (1) right-clicking anywhere in the Table of Contents and (2) choose “update field,” then “update page numbers only.” If you add or delete section headings, follow step (1) and (2) above and choose “update entire table.”*

	<u>Page</u>
1. Definitions.....	2
2. Agreement Among the Company, the Investors and the Key Holders.....	4
2.1 Right of First Refusal.....	4
2.2 Right of Co-Sale .....	6
2.3 Effect of Failure to Comply .....	8
3. Exempt Transfers .....	9
3.1 Exempted Transfers .....	9
3.2 Exempted Offerings.....	10
3.3 [Prohibited Transferees.....	10
4. Legend.....	10
5. Lock-Up .....	11
5.1 Agreement to Lock-Up .....	11
5.2 Stop Transfer Instructions.....	11
11	
6. Miscellaneous .....	11
6.1 Term.....	11
6.2 Stock Split.....	12
6.3 Ownership.....	12
6.4 Dispute Resolution.....	12
6.5 Notices .....	13
6.6 Entire Agreement.....	13
6.7 Delays or Omissions .....	14
6.8 Amendment; Waiver and Termination .....	14
6.9 Assignment of Rights.....	15
6.10 Severability .....	15
6.11 Additional Investors.....	15
6.12 Governing Law .....	16
6.13 Titles and Subtitles.....	16
6.14 Counterparts.....	16
6.15 [Aggregation of Stock.....	16
6.16 Specific Performance .....	16

6.17	[Additional Key Holders.....	16
6.18	[Consent of Spouse.....	17
6.19	[Effect on Prior Agreement.....	17
Schedule A	- Investors	
Schedule B	- Key Holders	
[Exhibit A	- Consent of Spouse]	

**[AMENDED AND RESTATED] RIGHT OF FIRST REFUSAL  
AND CO-SALE AGREEMENT**

THIS [AMENDED AND RESTATED] RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT is made as of the [ ] day of [ ], 20\_\_ by and among [ ], a [Delaware] corporation (the “**Company**”), the Investors listed on Schedule A and the Key Holders<sup>1</sup> listed on Schedule B.

*[Alternative 1:<sup>2</sup>*

WHEREAS, each Key Holder is the beneficial owner of the number of shares of Capital Stock, or of options to purchase Common Stock, set forth opposite the name of such Key Holder on Schedule B;

WHEREAS, the Company and the Investors are parties to the [Series A Preferred Stock] Purchase Agreement, of even date herewith (the “**Purchase Agreement**”), pursuant to which the Investors have agreed to purchase shares of the Series A Preferred Stock of the Company, par value \$\_\_ per share (“**Series A Preferred Stock**”); and

WHEREAS, the Key Holders and the Company desire to further induce the Investors to purchase the Series A Preferred Stock;]

*[Alternative 2:<sup>3</sup>*

WHEREAS, the Company, the Key Holders and certain of the Investors (the “**Prior Investors**”) previously entered into [a] [an] [Amended and Restated] Right of First Refusal and Co-Sale Agreement, dated [ ] \_\_, 20\_\_ (the “**Prior Agreement**”), in connection with the purchase of shares of Series [ ] Preferred Stock of the Company, par value \$\_\_ per share (“**Series [ ] Preferred Stock**”);

WHEREAS, the Key Holders, the Prior Investors and the Company desire to induce certain of the Investors to purchase shares of Series [ ] Preferred Stock of the Company, par value \$\_\_ per share, (“**Series [ ] Preferred Stock**”) pursuant to the Series [ ] Preferred Stock Purchase Agreement dated as of the date hereof by and among the Company and certain of the Investors (the “**Purchase Agreement**”) by amending and restating the Prior Agreement to provide the Investors with the rights and privileges as set forth herein].

NOW, THEREFORE, the Company, the Key Holders [and] [,] the Investors [including the Prior Investors each hereby agree to amend and restate the Prior Agreement in its entirety as set forth herein, and the parties hereto further] agree as follows:

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<sup>1</sup> In most cases investors will want the term “Key Holders” to include major common stock or option holders in addition to the individuals who actually founded the Company.

<sup>2</sup> This first set of recitals assumes that this Agreement is being entered into in connection with the sale of the Company’s first series of preferred stock.

<sup>3</sup> This second set of recitals assumes that a preexisting co-sale agreement is being superseded. It contemplates two different series of preferred stock. Appropriate modifications to the form will be required based on the actual series of preferred stock outstanding and the relative right of such series.

1. Definitions.

1.1 “**Affiliate**” means, with respect to any specified Investor, any other Investor who directly or indirectly, controls, is controlled by or is under common control with such Investor, including without limitation any general partner, managing member, officer or director of such Investor, or any venture capital fund now or hereafter existing which is controlled by one or more general partners or managing members of, or shares the same management company with, such Investor.

1.2 “**Capital Stock**” means (a) shares of Common Stock and Preferred Stock (whether now outstanding or hereafter issued in any context), (b) shares of Common Stock issued or issuable upon conversion of Preferred Stock and (c) shares of Common Stock issued or issuable upon exercise or conversion, as applicable, of stock options, warrants or other convertible securities of the Company, in each case now owned or subsequently acquired by any Key Holder, any Investor, or their respective successors or permitted transferees or assigns. For purposes of the number of shares of Capital Stock held by an Investor or Key Holder (or any other calculation based thereon), all shares of Preferred Stock shall be deemed to have been converted into Common Stock at the then-applicable conversion ratio.

1.3 “**Change of Control**” means a transaction or series of related transactions in which a person, or a group of related persons, acquires from stockholders of the Company shares representing more than fifty percent (50%) of the outstanding voting power of the Company.

1.4 “**Common Stock**” means shares of Common Stock of the Company, [ ] par value per share.

1.5 “**Company Notice**” means written notice from the Company notifying the selling Key Holders that the Company intends to exercise its Right of First Refusal as to some or all of the Transfer Stock with respect to any Proposed Key Holder Transfer.

1.6 “**Investor Notice**” means written notice from an Investor notifying the Company and the selling Key Holder that such Investor intends to exercise its Secondary Refusal Right as to a portion of the Transfer Stock with respect to any Proposed Key Holder Transfer.

1.7 “**Investors**” means the persons named on Schedule A hereto, each person to whom the rights of an Investor are assigned pursuant to Subsection 6.9, each person who hereafter becomes a signatory to this Agreement pursuant to Subsection 6.11 and any one of them, as the context may require [; provided, however, that any such person shall cease to be considered an Investor for purposes of this Agreement at any time such person and his, her or its Affiliates collectively hold fewer than [ ] shares of Capital Stock (as adjusted for any stock combination, stock split, stock dividend, recapitalization or other similar transaction)<sup>4</sup>].

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<sup>4</sup> This minimum shareholding requirement is sometimes expressed in terms of a certain percentage of the Company’s fully-diluted capitalization, in which case the Investor runs the risk of losing rights under this agreement if it fails to participate in future issuances.

1.8 “**Key Holders**” means the persons named on Schedule B hereto, each person to whom the rights of a Key Holder are assigned pursuant to Subsection 3.1, each person who hereafter becomes a signatory to this Agreement pursuant to Subsection 6.9 or 6.17 and any one of them, as the context may require.

1.9 “**Preferred Stock**” means collectively, all shares of Series A Preferred Stock [and Series [ ] Preferred Stock].<sup>5</sup>

1.10 “**Proposed Key Holder Transfer**” means any assignment, sale, offer to sell, pledge, mortgage, hypothecation, encumbrance, disposition of or any other like transfer or encumbering of any Transfer Stock (or any interest therein) proposed by any of the Key Holders.

1.11 “**Proposed Transfer Notice**” means written notice from a Key Holder setting forth the terms and conditions of a Proposed Key Holder Transfer.

1.12 “**Prospective Transferee**” means any person to whom a Key Holder proposes to make a Proposed Key Holder Transfer.

1.13 “**Restated Certificate**” means the Company’s Amended and Restated Certificate of Incorporation, as amended from time to time.

1.14 “**Right of Co-Sale**” means the right, but not an obligation, of an Investor to participate in a Proposed Key Holder Transfer on the terms and conditions specified in the Proposed Transfer Notice.

1.15 “**Right of First Refusal**” means the right, but not an obligation, of the Company, or its permitted transferees or assigns, to purchase some or all of the Transfer Stock with respect to a Proposed Key Holder Transfer, on the terms and conditions specified in the Proposed Transfer Notice.

1.16 “**Secondary Notice**” means written notice from the Company notifying the Investors and the selling Key Holder that the Company does not intend to exercise its Right of First Refusal as to all shares of Transfer Stock with respect to any Proposed Key Holder Transfer.

1.17 “**Secondary Refusal Right**” means the right, but not an obligation, of each Investor to purchase up to its pro rata portion (based upon the total number of shares of Capital Stock then held by all Investors) of any Transfer Stock not purchased pursuant to the Right of First Refusal, on the terms and conditions specified in the Proposed Transfer Notice.

1.18 “**Transfer Stock**” means shares of Capital Stock owned by a Key Holder, or issued to a Key Holder after the date hereof (including, without limitation, in connection with any stock split, stock dividend, recapitalization, reorganization, or the like), but does not include any shares of Preferred Stock or Common Stock issued or issuable upon conversion of Preferred Stock.

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<sup>5</sup> This definition may not be necessary in a Series A Financing. If it is not included, all references to Preferred Stock should be changed to Series A Preferred Stock.

1.19 “**Undersubscription Notice**” means written notice from an Investor notifying the Company and the selling Key Holder that such Investor intends to exercise its option to purchase all or any portion of the Transfer Stock not purchased pursuant to the Right of First Refusal or the Secondary Refusal Right.

2. Agreement Among the Company, the Investors and the Key Holders.

2.1 Right of First Refusal.<sup>6</sup>

(a) Grant. Subject to the terms of Section 3 below, each Key Holder<sup>7</sup> hereby unconditionally and irrevocably grants to the Company a Right of First Refusal to purchase all or any portion of Transfer Stock that such Key Holder may propose to transfer in a Proposed Key Holder Transfer, at the same price and on the same terms and conditions as those offered to the Prospective Transferee.

(b) Notice. Each Key Holder proposing to make a Proposed Key Holder Transfer must deliver a Proposed Transfer Notice to the Company and each Investor not later than [forty-five (45)] days prior to the consummation of such Proposed Key Holder Transfer. Such Proposed Transfer Notice shall contain the material terms and conditions (including price and form of consideration) of the Proposed Key Holder Transfer and the identity of the Prospective Transferee. To exercise its Right of First Refusal under this Section 2, the Company must deliver a Company Notice to the selling Key Holder within fifteen (15) days after delivery of the Proposed Transfer Notice. [In the event of a conflict between this Agreement and any other agreement that may have been entered into by a Key Holder with the Company that contains a preexisting right of first refusal, the Company and the Key Holder acknowledge and agree that the terms of this Agreement shall control and the preexisting right of first refusal shall be deemed satisfied by compliance with Subsection 2.1(a) and this Subsection 2.1(b).] [In the event of a conflict between this Agreement and the Company’s Bylaws containing a preexisting right of first refusal, the terms of the Bylaws will control and compliance with the Bylaws shall be deemed compliance with this Subsection 2.1(a) and (b) in full.]

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<sup>6</sup> Note the Delaware Court of Chancery’s holding in *Latesco, L.P. v. Wayport, Inc.*, Case No. C.A. 4167-VCL (Del. Ch. Ct. 7/24/09) that fiduciary disclosure principles do not apply to purchases by insiders pursuant to contractual ROFR provisions. The court essentially ruled that, under Delaware law, companies (as well as their officers and directors), are not required to disclose material non-public information to a seller before buying shares pursuant to ROFR provisions unless (1) the ROFR agreement expressly requires such disclosure or (2) the Company or the insiders purchasing the shares make statements to the seller that are misleading absent additional disclosure. The court’s decision does not necessarily imply a similar result under the federal securities laws.

<sup>7</sup> This form assumes that only transfers by Key Holders will be subject to a Right of First Refusal and a Right of Co-Sale. In certain circumstances, the Company or other Investors may request that the Investors also be subject to the same limitations on transfer as the Key Holders. Some Investors may feel that imposing a right of first refusal or a right of co-sale on other Investors is a necessary measure to protect the Preferred Stock liquidation preference against acquisitions that are structured as a tender offer which will not ordinarily trigger application of the liquidation preference in the Company’s Certificate of Incorporation (but note that co-sale rights would ordinarily provide the Investors with the same purchase price paid to the holders of Common Stock, rather than a higher price reflecting the liquidation preferences of the Preferred Stock. For further discussion of this point, see footnote 15 in the Voting Agreement). In other cases, Investors may wish to impose such restrictions on one another as means to police the composition of the Company’s stockholders, or to ensure that they have “first dibs” if and when other Investors sell their shares.

(c) Grant of Secondary Refusal Right to Investors. Subject to the terms of Section 3 below, each Key Holder hereby unconditionally and irrevocably grants to the Investors a Secondary Refusal Right to purchase all or any portion of the Transfer Stock not purchased by the Company pursuant to the Right of First Refusal, as provided in this Subsection 2.1(c). If the Company does not intend to exercise its Right of First Refusal with respect to all Transfer Stock subject to a Proposed Key Holder Transfer, the Company must deliver a Secondary Notice to the selling Key Holder and to each Investor to that effect no later than fifteen (15) days after the selling Key Holder delivers the Proposed Transfer Notice to the Company. To exercise its Secondary Refusal Right, an Investor must deliver an Investor Notice to the selling Key Holder and the Company within ten (10) days after the Company's deadline for its delivery of the Secondary Notice as provided in the preceding sentence.

(d) Undersubscription of Transfer Stock. If options to purchase have been exercised by the Company and the Investors with respect to some but not all of the Transfer Stock by the end of the 10-day period specified in the last sentence of Subsection 2.1(c) (the "**Investor Notice Period**"), then the Company shall, immediately after the expiration of the Investor Notice Period, send written notice (the "**Company Undersubscription Notice**") to those Investors who fully exercised their Secondary Refusal Right within the Investor Notice Period (the "**Exercising Investors**"). Each Exercising Investor shall, subject to the provisions of this Subsection 2.1(d), have an additional option to purchase all or any part of the balance of any such remaining unsubscribed shares of Transfer Stock on the terms and conditions set forth in the Proposed Transfer Notice. To exercise such option, an Exercising Investor must deliver an Undersubscription Notice to the selling Key Holder and the Company within ten (10) days after the expiration of the Investor Notice Period. In the event there are two or more such Exercising Investors that choose to exercise the last-mentioned option for a total number of remaining shares in excess of the number available, the remaining shares available for purchase under this Subsection 2.1(d) shall be allocated to such Exercising Investors pro rata based on the number of shares of Transfer Stock such Exercising Investors have elected to purchase pursuant to the Secondary Refusal Right (without giving effect to any shares of Transfer Stock that any such Exercising Investor has elected to purchase pursuant to the Company Undersubscription Notice). If the options to purchase the remaining shares are exercised in full by the Exercising Investors, the Company shall immediately notify all of the Exercising Investors and the selling Key Holder of that fact.

(e) [Forfeiture of Rights. Notwithstanding the foregoing, if the total number of shares of Transfer Stock that the Company and the Investors have agreed to purchase in the Company Notice, Investor Notices and Undersubscription Notices is less than the total number of shares of Transfer Stock, then the Company and the Investors shall be deemed to have forfeited any right to purchase such Transfer Stock, and the selling Key Holder shall be free to sell all, but not less than all, of the Transfer Stock to the Prospective Transferee on terms and conditions substantially similar to (and in no event more favorable than) the terms and conditions set forth in the Proposed Transfer Notice, it being understood and agreed that (i) any such sale or transfer shall be subject to the other terms and restrictions of this Agreement, including without limitation the terms and restrictions set forth in Subsections 2.2 and 6.9(b); (ii) any future Proposed Key Holder Transfer shall remain subject to the terms and conditions of this Agreement, including this Section 2; and (iii) such sale shall be consummated within forty-five (45) days after receipt of the Proposed Transfer Notice by the Company and, if such sale is not



consummated within such forty-five (45) day period, such sale shall again become subject to the Right of First Refusal and Secondary Refusal Right on the terms set forth herein.]<sup>8</sup>

(f) Consideration; Closing. If the consideration proposed to be paid for the Transfer Stock is in property, services or other non-cash consideration, the fair market value of the consideration shall be as determined in good faith by the Company's Board of Directors and as set forth in the Company Notice. If the Company or any Investor cannot for any reason pay for the Transfer Stock in the same form of non-cash consideration, the Company or such Investor may pay the cash value equivalent thereof, as determined in good faith by the Board of Directors and as set forth in the Company Notice. The closing of the purchase of Transfer Stock by the Company and the Investors shall take place, and all payments from the Company and the Investors shall have been delivered to the selling Key Holder, by the later of (i) the date specified in the Proposed Transfer Notice as the intended date of the Proposed Key Holder Transfer and (ii) [forty-five (45)] days after delivery of the Proposed Transfer Notice.

## 2.2 Right of Co-Sale.

(a) Exercise of Right. If any Transfer Stock subject to a Proposed Key Holder Transfer is not purchased pursuant to Subsection 2.1 above and thereafter is to be sold to a Prospective Transferee, each respective Investor may elect to exercise its Right of Co-Sale and participate on a pro rata basis in the Proposed Key Holder Transfer as set forth in Subsection 2.2(b) below and, subject to Subsection 2.2(d), otherwise on the same terms and conditions specified in the Proposed Transfer Notice. Each Investor who desires to exercise its Right of Co-Sale (each, a "**Participating Investor**") must give the selling Key Holder written notice to that effect within fifteen (15) days after the deadline for delivery of the Secondary Notice described above, and upon giving such notice such Participating Investor shall be deemed to have effectively exercised the Right of Co-Sale.

(b) Shares Includable. Each Participating Investor may include in the Proposed Key Holder Transfer all or any part of such Participating Investor's Capital Stock equal to the product obtained by multiplying (i) the aggregate number of shares of Transfer Stock subject to the Proposed Key Holder Transfer (excluding shares purchased by the Company or the Participating Investors pursuant to the Right of First Refusal or the Secondary Refusal Right) by (ii) a fraction, the numerator of which is the number of shares of Capital Stock owned by such Participating Investor immediately before consummation of the Proposed Key Holder Transfer [(including any shares that such Investor has agreed to purchase pursuant to the Secondary Refusal Right)] and the denominator of which is the total number of shares of Capital Stock owned, in the aggregate, by all Participating Investors immediately prior to the consummation of

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<sup>8</sup> The "all or nothing" concept contained in this paragraph makes the right of first refusal provisions less onerous for the Key Holder, in that the Company and the Investors cannot simply chip away at the deal he or she has struck with the Prospective Transferee; they must either purchase all of the Transfer Stock or let the sale to the Prospective Transferee proceed undisturbed, subject to the Right of Co-Sale. This paragraph would be particularly valuable to a Key Holder that had a controlling interest in the Company and was only able to attract a purchaser by offering to sell that interest to one party (who would not be interested in purchasing a smaller interest). If this paragraph is included, it is probably a good idea to include the preceding paragraph regarding undersubscriptions so that one Investor cannot cause everyone to lose their right of first refusal by refusing to purchase its pro rata share.

the Proposed Key Holder Transfer [(including any shares that all Participating Investors have collectively agreed to purchase pursuant to the Secondary Refusal Right)], plus the number of shares of Transfer Stock held by the [selling Key Holder] [Key Holders]. [To the extent one or more of the Participating Investors exercise such right of participation in accordance with the terms and conditions set forth herein, the number of shares of Transfer Stock that the selling Key Holder may sell in the Proposed Key Holder Transfer shall be correspondingly reduced.]

(c) Purchase and Sale Agreement. The Participating Investors and the selling Key Holder agree that the terms and conditions of any Proposed Key Holder Transfer in accordance with Subsection 2.2 will be memorialized in, and governed by, a written purchase and sale agreement with the Prospective Transferee (the “**Purchase and Sale Agreement**”) with customary terms and provisions for such a transaction, and the Participating Investors and the selling Key Holder further covenant and agree to enter into such Purchase and Sale Agreement as a condition precedent to any sale or other transfer in accordance with this Subsection 2.2.

(d) Allocation of Consideration.

(i) Subject to Subsection 2.2(d)(ii), the aggregate consideration payable to the Participating Investors and the selling Key Holder shall be allocated based on the number of shares of Capital Stock sold to the Prospective Transferee by each Participating Investor and the selling Key Holder as provided in Subsection 2.2(b), provided that if a Participating Investor wishes to sell Preferred Stock, the price set forth in the Proposed Transfer Notice shall be appropriately adjusted based on the conversion ratio of the Preferred Stock into Common Stock.

(ii) In the event that the Proposed Key Holder Transfer constitutes a Change of Control, the terms of the Purchase and Sale Agreement shall provide that the aggregate consideration from such transfer shall be allocated to the Participating Investors and the selling Key Holder in accordance with Sections 2.1 and 2.2 of Article IV(B) of the Restated Certificate as if (A) such transfer were a Deemed Liquidation Event (as defined in the Restated Certificate) and (B) the Capital Stock sold in accordance with the Purchase and Sale Agreement were the only Capital Stock outstanding.<sup>9</sup> [In the event that a portion of the aggregate consideration payable to the Participating Investor(s) and selling Key Holder is placed into escrow, the Purchase and Sale Agreement shall provide that (x) the portion of such consideration that is not placed in escrow (the “**Initial Consideration**”) shall be allocated in accordance with Sections 2.1 and 2.2 of Article IV(B) of the Restated Certificate as if the Initial Consideration were the only consideration payable in connection with such transfer and (y) any additional consideration which becomes payable to the Participating Investor(s) and selling Key Holder upon release from escrow shall be allocated in accordance with Sections 2.1 and 2.2 of Article IV(B) of the Restated Certificate after taking into account the previous payment of the Initial Consideration as part of the same transfer.]<sup>10</sup>

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<sup>9</sup> This provision allows the investors to receive their liquidation preference in the event that the majority stockholders sell their shares directly to a third party.

<sup>10</sup> Use the bracketed language if you use Subsection 2.3.4 (Allocation of Escrow) from the Model Charter.

(e) Purchase by Selling Key Holder; Deliveries. Notwithstanding Subsection 2.2(c) above, if any Prospective Transferee or Transferees refuse(s) to purchase securities subject to the Right of Co-Sale from any Participating Investor or Investors or upon the failure to negotiate [in good faith] a Purchase and Sale Agreement [reasonably] satisfactory to the Participating Investors, no Key Holder may sell any Transfer Stock to such Prospective Transferee or Transferees unless and until, simultaneously with such sale, such Key Holder purchases all securities subject to the Right of Co-Sale from such Participating Investor or Investors on the same terms and conditions (including the proposed purchase price) as set forth in the Proposed Transfer Notice and as provided in Subsection 2.2(d)(i); provided, however, if such sale constitutes a Change of Control, the portion of the aggregate consideration paid by the selling Key Holder to such Participating Investor or Investors shall be made in accordance with the first sentence of Subsection 2.2(d)(ii). In connection with such purchase by the selling Key Holder, such Participating Investor or Investors shall deliver to the selling Key Holder a stock certificate or certificates, properly endorsed for transfer, representing the Capital Stock being purchased by the selling Key Holder. Each such stock certificate delivered to the selling Key Holder will be transferred to the Prospective Transferee against payment therefor in consummation of the sale of the Transfer Stock pursuant to the terms and conditions specified in the Proposed Transfer Notice, and the selling Key Holder shall concurrently therewith remit or direct payment to each such Participating Investor the portion of the aggregate consideration to which each such Participating Investor is entitled by reason of its participation in such sale as provided in this Subsection 2.2(e).

(f) Additional Compliance. If any Proposed Key Holder Transfer is not consummated within [forty-five (45)<sup>11</sup>] days after receipt of the Proposed Transfer Notice by the Company, the Key Holders proposing the Proposed Key Holder Transfer may not sell any Transfer Stock unless they first comply in full with each provision of this Section 2. The exercise or election not to exercise any right by any Investor hereunder shall not adversely affect its right to participate in any other sales of Transfer Stock subject to this Subsection 2.2.

### 2.3 Effect of Failure to Comply.

(a) Transfer Void; Equitable Relief. Any Proposed Key Holder Transfer not made in compliance with the requirements of this Agreement shall be null and void ab initio, shall not be recorded on the books of the Company or its transfer agent and shall not be recognized by the Company. Each party hereto acknowledges and agrees that any breach of this Agreement would result in substantial harm to the other parties hereto for which monetary damages alone could not adequately compensate. Therefore, the parties hereto unconditionally and irrevocably agree that any non-breaching party hereto shall be entitled to seek protective orders, injunctive relief and other remedies available at law or in equity (including, without limitation, seeking specific performance or the rescission of purchases, sales and other transfers of Transfer Stock not made in strict compliance with this Agreement).

(b) Violation of First Refusal Right. If any Key Holder becomes obligated to sell any Transfer Stock to the Company or any Investor under this Agreement and fails to deliver such Transfer Stock in accordance with the terms of this Agreement, the

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<sup>11</sup> Logistical considerations may make a 60-day period more reasonable.

Company and/or such Investor may, at its option, in addition to all other remedies it may have, send to such Key Holder the purchase price for such Transfer Stock as is herein specified and transfer to the name of the Company or such Investor (or request that the Company effect such transfer in the name of an Investor) on the Company's books the certificate or certificates representing the Transfer Stock to be sold.

(c) Violation of Co-Sale Right. If any Key Holder purports to sell any Transfer Stock in contravention of the Right of Co-Sale (a "**Prohibited Transfer**"), each Investor who desires to exercise its Right of Co-Sale under Subsection 2.2 may, in addition to such remedies as may be available by law, in equity or hereunder, require such Key Holder to purchase from such Investor the type and number of shares of Capital Stock that such Investor would have been entitled to sell to the Prospective Transferee had the Prohibited Transfer been effected in compliance with the terms of Subsection 2.2. The sale will be made on the same terms, including, without limitation, as provided in Subsection 2.2(d)(i) and the first sentence of Subsection 2.2(d)(ii), as applicable, and subject to the same conditions as would have applied had the Key Holder not made the Prohibited Transfer, except that the sale (including, without limitation, the delivery of the purchase price) must be made within ninety (90) days after the Investor learns of the Prohibited Transfer, as opposed to the timeframe proscribed in Subsection 2.2. Such Key Holder shall also reimburse each Investor for any and all reasonable and documented out-of-pocket fees and expenses, including reasonable legal fees and expenses, incurred pursuant to the exercise or the attempted exercise of the Investor's rights under Subsection 2.2.

### 3. Exempt Transfers.<sup>12</sup>

3.1 Exempted Transfers. Notwithstanding the foregoing or anything to the contrary herein, the provisions of Subsections 2.1 and 2.2 shall not apply: (a) in the case of a Key Holder that is an entity, upon a transfer by such Key Holder to its stockholders, members, partners or other equity holders, (b) to a repurchase of Transfer Stock from a Key Holder by the Company at a price no greater than that originally paid by such Key Holder for such Transfer Stock and pursuant to an agreement containing vesting and/or repurchase provisions approved by a majority of the Board of Directors, [(c) to a pledge of Transfer Stock that creates a mere security interest in the pledged Transfer Stock, provided that the pledgee thereof agrees in writing in advance to be bound by and comply with all applicable provisions of this Agreement to the same extent as if it were the Key Holder making such pledge,] [or] (d) in the case of a Key Holder that is a natural person, upon a transfer of Transfer Stock by such Key Holder made for bona fide estate planning purposes, either during his or her lifetime or on death by will or intestacy to his or her spouse, child (natural or adopted), or any other direct lineal descendant of such Key Holder (or his or her spouse) (all of the foregoing collectively referred to as "family members"), or any other [relative/person] approved by [unanimous consent of] the Board of Directors of the Company, or any custodian or trustee of any trust, partnership or limited liability company for the benefit of, or the ownership interests of which are owned wholly by, such Key Holder or any such family members, [or (e) to the sale by the Key Holder of up to [\_\_%] of the

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<sup>12</sup> Often the definition of a "Permitted Transfer" is negotiated on a case by case basis. For example, a Key Holder may wish to be permitted to Transfer a *de minimis* amount of Shares to a third party, such as a charity. However, the examples set forth herein are fairly standard and found in many co-sale agreements.

Transfer Stock held by such Key Holder as of the date that such Key Holder first became party to this Agreement]; provided that in the case of clause(s) [(a)], [(c)], [(d)] or [(e)], the Key Holder shall deliver prior written notice to the Investors of such pledge, gift or transfer and such shares of Transfer Stock shall at all times remain subject to the terms and restrictions set forth in this Agreement and such transferee shall, as a condition to such issuance, deliver a counterpart signature page to this Agreement as confirmation that such transferee shall be bound by all the terms and conditions of this Agreement as a Key Holder (but only with respect to the securities so transferred to the transferee), including the obligations of a Key Holder with respect to Proposed Key Holder Transfers of such Transfer Stock pursuant to Section 2 [; and provided, further, in the case of any transfer pursuant to clause (a) or (d) above, that such transfer is made pursuant to a transaction in which there is no consideration actually paid for such transfer].

3.2 Exempted Offerings. Notwithstanding the foregoing or anything to the contrary herein, the provisions of Section 2 shall not apply to the sale of any Transfer Stock (a) to the public in an offering pursuant to an effective registration statement under the Securities Act of 1933, as amended (a “**Public Offering**”) or (b) pursuant to a Deemed Liquidation Event (as defined in the Company’s Certificate of Incorporation).

3.3 [Prohibited Transferees. Notwithstanding the foregoing, no Key Holder shall transfer any Transfer Stock to (a) any entity which, in the determination of the Company’s Board of Directors, directly or indirectly competes with the Company or (b) any customer, distributor or supplier of the Company, if the Company’s Board of Directors should determine that such transfer would result in such customer, distributor or supplier receiving information that would place the Company at a competitive disadvantage with respect to such customer, distributor or supplier.]

4. Legend. Each certificate representing shares of Transfer Stock held by the Key Holders or issued to any permitted transferee in connection with a transfer permitted by Subsection 3.1 hereof shall be endorsed with the following legend:

THE SALE, PLEDGE, HYPOTHECATION OR TRANSFER OF THE SECURITIES REPRESENTED BY THIS CERTIFICATE IS SUBJECT TO, AND IN CERTAIN CASES PROHIBITED BY, THE TERMS AND CONDITIONS OF A CERTAIN RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT BY AND AMONG THE STOCKHOLDER, THE CORPORATION AND CERTAIN OTHER HOLDERS OF STOCK OF THE CORPORATION. COPIES OF SUCH AGREEMENT MAY BE OBTAINED UPON WRITTEN REQUEST TO THE SECRETARY OF THE CORPORATION.

Each Key Holder agrees that the Company may instruct its transfer agent to impose transfer restrictions on the shares represented by certificates bearing the legend referred to in this Section 4 above to enforce the provisions of this Agreement, and the Company agrees to promptly do so. The legend shall be removed upon termination of this Agreement at the request of the holder.

## 5. Lock-Up.

5.1 Agreement to Lock-Up. Each Key Holder hereby agrees that it will not, without the prior written consent of the managing underwriter, during the period commencing on the date of the final prospectus relating to the Company's initial public offering (the "IPO") and ending on the date specified by the Company and the managing underwriter [(such period not to exceed 180 days)] [, or such other period as may be requested by the Company or an underwriter to accommodate regulatory restrictions on (1) the publication or other distribution of research reports and (2) analyst recommendations and opinions, including, but not limited to, the restrictions contained in FINRA Rule 2711(f)(4) or NYSE Rule 472(f)(4), or any successor provisions or amendments thereto)],<sup>13</sup> (a) lend, offer, pledge, sell, contract to sell, sell any option or contract to purchase, purchase any option or contract to sell, grant any option, right or warrant to purchase, or otherwise transfer or dispose of, directly or indirectly, any shares of Capital Stock held immediately prior to the effectiveness of the registration statement for the IPO or (b) enter into any swap or other arrangement that transfers to another, in whole or in part, any of the economic consequences of ownership of the Capital Stock, whether any such transaction described in clause (a) or (b) above is to be settled by delivery of Capital Stock or other securities, in cash or otherwise. The foregoing provisions of this Section 5 shall not apply to the sale of any shares to an underwriter pursuant to an underwriting agreement, and shall only be applicable to the Key Holders if all officers, directors and holders of more than one percent (1%) of the outstanding Common Stock (after giving effect to the conversion into Common Stock of all outstanding [Series A] Preferred Stock) enter into similar agreements. The underwriters in connection with the IPO are intended third-party beneficiaries of this Section 5 and shall have the right, power and authority to enforce the provisions hereof as though they were a party hereto. Each Key Holder further agrees to execute such agreements as may be reasonably requested by the underwriters in the IPO that are consistent with this Section 5 or that are necessary to give further effect thereto.

5.2 Stop Transfer Instructions. In order to enforce the foregoing covenant, the Company may impose stop-transfer instructions with respect to the shares of Capital Stock of each Key Holder (and transferees and assignees thereof) until the end of such restricted period.

## 6. Miscellaneous.

6.1 Term. This Agreement shall automatically terminate upon the earlier of (a) immediately prior to the consummation of the Company's IPO and (b) the consummation of a Deemed Liquidation Event (as defined in the Restated Certificate).

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<sup>13</sup> The bracketed language is intended to address the fact that FINRA Rule 2711(f)(4) and NYSE Rule 472 each prohibit the publication or other distribution of a research report or the making of a public appearance concerning a subject company by a member 15 days prior to and after the expiration, waiver or termination of a lock-up agreement or any other agreement that the member has entered into with a subject company or its shareholders that restricts or prohibits the sale of securities held by the subject company or its shareholders after the completion of a securities offering, unless the securities are "actively traded" within the meaning of Rule 101(c)(1) of Regulation M under the Exchange Act. Some underwriters are actually going farther and requiring that lockup periods be extended to up to a total of 210 days in order to give them sufficient leeway.

6.2 Stock Split. All references to numbers of shares in this Agreement shall be appropriately adjusted to reflect any stock dividend, split, combination or other recapitalization affecting the Capital Stock occurring after the date of this Agreement.

6.3 Ownership. Each Key Holder represents and warrants that such Key Holder is the sole legal and beneficial owner of the shares of Transfer Stock subject to this Agreement and that no other person or entity has any interest in such shares (other than a community property interest as to which the holder thereof has acknowledged and agreed in writing to the restrictions and obligations hereunder).

6.4 Dispute Resolution.<sup>14</sup> The parties (a) hereby irrevocably and unconditionally submit to the jurisdiction of the state courts of [state] and to the jurisdiction of the United States District Court for the District of [judicial district] for the purpose of any suit, action or other proceeding arising out of or based upon this Agreement, (b) agree not to commence any suit, action or other proceeding arising out of or based upon this Agreement except in the state courts of [state] or the United States District Court for the District of [judicial district], and (c) hereby waive, and agree not to assert, by way of motion, as a defense, or otherwise, in any such suit, action or proceeding, any claim that it is not subject personally to the jurisdiction of the above-named courts, that its property is exempt or immune from attachment or execution, that the suit, action or proceeding is brought in an inconvenient forum, that the venue of the suit, action or proceeding is improper or that this Agreement or the subject matter hereof may not be enforced in or by such court.

WAIVER OF JURY TRIAL: EACH PARTY HEREBY WAIVES ITS RIGHTS TO A JURY TRIAL OF ANY CLAIM OR CAUSE OF ACTION BASED UPON OR ARISING OUT OF THIS AGREEMENT, THE OTHER TRANSACTION DOCUMENTS, THE SECURITIES OR THE SUBJECT MATTER HEREOF OR THEREOF. THE SCOPE OF THIS WAIVER IS INTENDED TO BE ALL-ENCOMPASSING OF ANY AND ALL DISPUTES THAT MAY BE FILED IN ANY COURT AND THAT RELATE TO THE SUBJECT MATTER OF THIS TRANSACTION, INCLUDING, WITHOUT LIMITATION, CONTRACT CLAIMS, TORT CLAIMS (INCLUDING NEGLIGENCE), BREACH OF DUTY CLAIMS, AND ALL OTHER COMMON LAW AND STATUTORY CLAIMS. THIS SECTION HAS BEEN FULLY DISCUSSED BY EACH OF THE PARTIES HERETO AND THESE PROVISIONS WILL NOT BE SUBJECT TO ANY EXCEPTIONS. EACH PARTY HERETO HEREBY FURTHER WARRANTS AND REPRESENTS THAT SUCH PARTY HAS REVIEWED THIS WAIVER WITH ITS LEGAL COUNSEL, AND THAT SUCH PARTY KNOWINGLY AND VOLUNTARILY WAIVES ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL

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<sup>14</sup> In the prior version of the NVCA Model Documents it was noted that in 2009 Delaware enacted legislation permitting confidential arbitration of disputes before a sitting Delaware Chancery Court Chancellor so long as 1) at least one party is a Delaware business entity or has its principal place of business in Delaware and 2) there is at least \$1 million in controversy. However, in August 2012 the U.S. District Court for the District of Delaware held in *Delaware Coalition for Open Government v. Strine* (D. Del. Aug. 30, 2012) that such confidential arbitration violates the First Amendment's right of access to civil trials. For so long as this decision stands (the State of Delaware reportedly plans to appeal), it seems imprudent to include a provision stipulating that disputes are to be arbitrated in the Delaware Court of Chancery.

[*Alternative*: Any unresolved controversy or claim arising out of or relating to this Agreement, except as (i) otherwise provided in this Agreement, or (ii) any such controversies or claims arising out of either party's intellectual property rights for which a provisional remedy or equitable relief is sought, shall be submitted to arbitration by one arbitrator mutually agreed upon by the parties, and if no agreement can be reached within thirty (30) days after names of potential arbitrators have been proposed by the American Arbitration Association (the "AAA"), then by one arbitrator having reasonable experience in corporate finance transactions of the type provided for in this Agreement and who is chosen by the AAA. The arbitration shall take place in [location], in accordance with the AAA rules then in effect, and judgment upon any award rendered in such arbitration will be binding and may be entered in any court having jurisdiction thereof. There shall be limited discovery prior to the arbitration hearing as follows: (a) exchange of witness lists and copies of documentary evidence and documents relating to or arising out of the issues to be arbitrated, (b) depositions of all party witnesses and (c) such other depositions as may be allowed by the arbitrators upon a showing of good cause. Depositions shall be conducted in accordance with the [State] Code of Civil Procedure, the arbitrator shall be required to provide in writing to the parties the basis for the award or order of such arbitrator, and a court reporter shall record all hearings, with such record constituting the official transcript of such proceedings.

[Each party will bear its own costs in respect of any disputes arising under this Agreement.] [The prevailing party shall be entitled to reasonable attorney's fees, costs, and necessary disbursements in addition to any other relief to which such party may be entitled.] Each of the parties to this Agreement consents to personal jurisdiction for any equitable action sought in the U.S. District Court for the District of [\_\_\_\_\_] or any court of the [State][Commonwealth] of [state] having subject matter jurisdiction.]

6.5 Notices. All notices and other communications given or made pursuant to this Agreement shall be in writing and shall be deemed effectively given upon the earlier of actual receipt or: (a) personal delivery to the party to be notified, (b) when sent, if sent by electronic mail or facsimile during normal business hours of the recipient, and if not sent during normal business hours, then on the recipient's next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) business day after deposit with a nationally recognized overnight courier, freight prepaid, specifying next business day delivery, with written verification of receipt. All communications shall be sent to the respective parties at their address as set forth on Schedule A or Schedule B hereof, as the case may be, or to such email address, facsimile number or address as subsequently modified by written notice given in accordance with this Section 6.5. If notice is given to the Company, it shall be sent to [Company Address, Attention: \_\_\_\_\_]; and a copy (which shall not constitute notice) shall also be sent to [Company Counsel Name and Address]; and if notice is given to the Investors, a copy shall also be given to [Investor Counsel Name and Address].

6.6 Entire Agreement. This Agreement (including the Exhibits and Schedules hereto) constitutes the full and entire understanding and agreement between the parties with respect to the subject matter hereof, and any other written or oral agreement relating to the subject matter hereof existing between the parties are expressly canceled.



6.7 Delays or Omissions. No delay or omission to exercise any right, power or remedy accruing to any party under this Agreement, upon any breach or default of any other party under this Agreement, shall impair any such right, power or remedy of such non-breaching or non-defaulting party nor shall it be construed to be a waiver of any such breach or default, or an acquiescence therein, or of or in any similar breach or default thereafter occurring; nor shall any waiver of any single breach or default be deemed a waiver of any other breach or default theretofore or thereafter occurring. Any waiver, permit, consent or approval of any kind or character on the part of any party of any breach or default under this Agreement, or any waiver on the part of any party of any provisions or conditions of this Agreement, must be in writing and shall be effective only to the extent specifically set forth in such writing. All remedies, either under this Agreement or by law or otherwise afforded to any party, shall be cumulative and not alternative.

6.8 Amendment; Waiver and Termination. This Agreement may be amended, modified or terminated (other than pursuant to Section 6.1 above) and the observance of any term hereof may be waived (either generally or in a particular instance and either retroactively or prospectively) only by a written instrument executed by (a) the Company, (b) the Key Holders holding [specify percentage] of the shares of Transfer Stock then held by all of the Key Holders [provided that such consent shall not be required if the Key Holders do not then own shares of Capital Stock representing at least [ ]% of the outstanding Capital Stock of the Company] [who are then providing services to the Company as officers, employees or consultants] and (c) the holders of [specify percentage] of the shares of Common Stock issued or issuable upon conversion of the then outstanding shares of Preferred Stock held by the Investors (voting as a single class and on an as-converted basis). Any amendment, modification, termination or waiver so effected shall be binding upon the Company, the Investors, the Key Holders and all of their respective successors and permitted assigns whether or not such party, assignee or other shareholder entered into or approved such amendment, modification, termination or waiver. [Notwithstanding the foregoing, (i) this Agreement may not be amended, modified or terminated and the observance of any term hereunder may not be waived with respect to any Investor or Key Holder without the written consent of such Investor or Key Holder unless such amendment, modification, termination or waiver applies to all Investors and Key Holders, respectively, in the same fashion and (ii) the consent of the Key Holders shall not be required for any amendment, modification, termination or waiver if such amendment, modification, termination or waiver does not apply to the Key Holders, and (iii) Schedule A hereto may be amended by the Company from time to time in accordance with the Purchase Agreement to add information regarding Additional Purchasers (as defined in the Purchase Agreement) without the consent of the other parties hereto.]<sup>15</sup> The Company shall give prompt written notice of any amendment, modification or termination hereof or waiver hereunder to any party hereto that did not consent in writing to such amendment, modification, termination or waiver. No waivers of or exceptions to any term, condition or provision of this Agreement, in any one or more instances, shall be deemed to be, or construed as, a further or continuing waiver of any such term, condition or provision.

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<sup>15</sup> There may be situations when a party is asked to waive or amend a right but not all similarly situated parties are required to do so. Consider a provision that indicates a party may waive or amend his own rights without having to obtain the consent of all of the others who are a part of his or her group.

## 6.9 Assignment of Rights.

(a) The terms and conditions of this Agreement shall inure to the benefit of and be binding upon the respective successors and permitted assigns of the parties. Nothing in this Agreement, express or implied, is intended to confer upon any party other than the parties hereto or their respective successors and permitted assigns any rights, remedies, obligations, or liabilities under or by reason of this Agreement, except as expressly provided in this Agreement.

(b) Any successor or permitted assignee of any Key Holder, including any Prospective Transferee who purchases shares of Transfer Stock in accordance with the terms hereof, shall deliver to the Company and the Investors, as a condition to any transfer or assignment, a counterpart signature page hereto pursuant to which such successor or permitted assignee shall confirm their agreement to be subject to and bound by all of the provisions set forth in this Agreement that were applicable to the predecessor or assignor of such successor or permitted assignee.<sup>16</sup>

(c) The rights of the Investors hereunder are not assignable without the Company's written consent (which shall not be unreasonably withheld, delayed or conditioned), except (i) by an Investor to any Affiliate or (ii) to an assignee or transferee who acquires at least [ ] shares of Capital Stock (as adjusted for any stock combination, stock split, stock dividend, recapitalization or other similar transaction), it being acknowledged and agreed that any such assignment, including an assignment contemplated by the preceding clauses (i) or (ii) shall be subject to and conditioned upon any such assignee's delivery to the Company and the other Investors of a counterpart signature page hereto pursuant to which such assignee shall confirm their agreement to be subject to and bound by all of the provisions set forth in this Agreement that were applicable to the assignor of such assignee.

(d) Except in connection with an assignment by the Company by operation of law to the acquirer of the Company, the rights and obligations of the Company hereunder may not be assigned under any circumstances.

6.10 Severability. The invalidity or unenforceability of any provision hereof shall in no way affect the validity or enforceability of any other provision.

6.11 Additional Investors. Notwithstanding anything to the contrary contained herein, if the Company issues additional shares of the Company's Series [ ] Preferred Stock after the date hereof, any purchaser of such shares of Series [ ] Preferred Stock may become a party to this Agreement by executing and delivering an additional counterpart signature page to this Agreement and thereafter shall be deemed an "Investor" for all purposes hereunder.

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<sup>16</sup> It can be a point of negotiation as to whether a Key Holder transferee should be required to take shares subject to the first refusal and co-sale restrictions of the agreement.

6.12 Governing Law.<sup>17</sup> This Agreement shall be governed by the internal law of the [State of Delaware].<sup>18</sup>

6.13 Titles and Subtitles. The titles and subtitles used in this Agreement are used for convenience only and are not to be considered in construing or interpreting this Agreement.

6.14 Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. Counterparts may be delivered via facsimile, electronic mail (including pdf) or other transmission method and any counterpart so delivered shall be deemed to have been duly and validly delivered and be valid and effective for all purposes.

6.15 [Aggregation of Stock. All shares of Capital Stock held or acquired by Affiliated entities or persons shall be aggregated together for the purpose of determining the availability of any rights under this Agreement and such Affiliated persons may apportion such rights as among themselves in any manner they deem appropriate.]<sup>19</sup>

6.16 Specific Performance. In addition to any and all other remedies that may be available at law in the event of any breach of this Agreement, each Investor shall be entitled to specific performance of the agreements and obligations of the Company and the Key Holders hereunder and to such other injunction or other equitable relief as may be granted by a court of competent jurisdiction.

6.17 [Additional Key Holders. In the event that after the date of this Agreement, the Company issues shares of Common Stock, or options to purchase Common Stock, to any employee or consultant, which shares or options would collectively constitute with respect to such employee or consultant (taking into account all shares of Common Stock, options and other purchase rights held by such employee or consultant) one percent (1%) or more of the Company's then outstanding Common Stock (treating for this purpose all shares of Common Stock issuable upon exercise of or conversion of outstanding options, warrants or convertible securities, as if exercised or converted), the Company shall, as a condition to such issuance, cause such employee or consultant to execute a counterpart signature page hereto as a Key

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<sup>17</sup> After choosing the applicable law, the parties should determine whether such law imposes any particular requirements, such as special legends or other notices, in order to make restrictions on transfer of shares effective.

<sup>18</sup> Some practitioners may select Delaware law as it has historically been the richest source for corporation law precedent. Other practitioners will prefer to choose the (non-Delaware) jurisdiction in which they are admitted to practice, if for no other reason than not having to retain Delaware counsel in the event they are called upon to give an enforceability opinion. In *Abry Partners V v. F&W Acquisition LLC, Case No. C.A. 1756-N (Del Ch, Ct. 2/14/06)*, the Delaware Chancery Court stated that it would respect a Delaware choice of law provision so long as Delaware law has a material relationship to the transaction – which will very often be the case in venture financings (e.g., parties are Delaware corporation, LLPs, or LLCs). However, it should be noted that if an action is brought in a jurisdiction other than the state whose governing law has been selected, that jurisdiction will apply its own choice of law principles in deciding whether or not to give effect to the governing law selected by the parties. Further, under the internal affairs doctrine of the state whose law is chosen to govern the agreement, whether or not the parties so provide, the DGCL will apply to certain provisions (e.g. voting of shares of stock).

<sup>19</sup> This provision is only needed if the proviso at the end of the definition of "Investors" is included.

Holder, and such person shall thereby be bound by, and subject to, all the terms and provisions of this Agreement applicable to a Key Holder.]

6.18 [Consent of Spouse]. If any Key Holder is married on the date of this Agreement, such Key Holder's spouse shall execute and deliver to the Company a consent of spouse in the form of Exhibit A hereto ("**Consent of Spouse**"), effective on the date hereof. Notwithstanding the execution and delivery thereof, such consent shall not be deemed to confer or convey to the spouse any rights in such Key Holder's shares of Transfer Stock that do not otherwise exist by operation of law or the agreement of the parties. If any Key Holder should marry or remarry subsequent to the date of this Agreement, such Key Holder shall within thirty (30) days thereafter obtain his/her new spouse's acknowledgement of and consent to the existence and binding effect of all restrictions contained in this Agreement by causing such spouse to execute and deliver a Consent of Spouse acknowledging the restrictions and obligations contained in this Agreement and agreeing and consenting to the same.]<sup>20</sup>

6.19 [Effect on Prior Agreement]. Upon the execution and delivery of this Agreement by the Company, the Key Holders holding a majority in interest of the Transfer Stock and the holders of at least a majority in interest of the Capital Stock held by those Investors who are party to the Prior Agreement (measured before giving effect to any purchase of shares of Series [ ] Preferred Stock by such Investors), the Prior Agreement automatically shall terminate and be of no further force and effect and shall be amended and restated in its entirety as set forth in this Agreement.]<sup>21</sup>

[Remainder of Page Intentionally Left Blank]

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<sup>20</sup> To the extent any Key Holder or spouse thereof is a resident of Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin, or the Commonwealth of Puerto Rico, a spousal consent may need to be executed. See Exhibit A. The necessity of such a consent should be researched carefully, as including this provision where the law is unclear may imply the existence of rights that would not otherwise exist.

<sup>21</sup> The drafter should ensure that the relevant signatories to the current agreement have authority to terminate the prior agreement under the terms of the prior agreement.

IN WITNESS WHEREOF, the parties have executed this [Amended and Restated] Right of First Refusal and Co-Sale Agreement as of the date first written above.

*[Insert Company Name]*

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

KEY HOLDERS:

Signature: \_\_\_\_\_

Name: \_\_\_\_\_

INVESTORS:

By: \_\_\_\_\_

Name: \_\_\_\_\_

Title: \_\_\_\_\_

**SCHEDULE A**  
**INVESTORS**

**Name and Address**

**Number of Shares Held**

**SCHEDULE B**  
**KEY HOLDERS**

**Name and Address**

**Number of Shares Held**

**[EXHIBIT A  
CONSENT OF SPOUSE]**

I, [\_\_\_\_\_] , spouse of [\_\_\_\_\_] , acknowledge that I have read the [Amended and Restated] Right of First Refusal and Co-Sale Agreement, dated as of [\_\_\_\_\_] , 20\_\_], to which this Consent is attached as Exhibit A (the “**Agreement**”), and that I know the contents of the Agreement. I am aware that the Agreement contains provisions regarding certain rights to certain other holders of Capital Stock of the Company upon a Proposed Key Holder Transfer of shares of Transfer Stock of the Company which my spouse may own including any interest I might have therein.

I hereby agree that my interest, if any, in any shares of Transfer Stock of the Company subject to the Agreement shall be irrevocably bound by the Agreement and further understand and agree that any community property interest I may have in such shares of Transfer Stock of the Company shall be similarly bound by the Agreement.

I am aware that the legal, financial and related matters contained in the Agreement are complex and that I am free to seek independent professional guidance or counsel with respect to this Consent. I have either sought such guidance or counsel or determined after reviewing the Agreement carefully that I will waive such right.

Dated as of the [\_\_] day of [\_\_\_\_\_, \_\_\_\_].

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Print Name



**This sample document is the work product of a coalition of attorneys who specialize in venture capital financings, working under the auspices of the NVCA. See the NVCA website for a list of the Working Group members. This document is intended to serve as a starting point only, and should be tailored to meet your specific requirements. This document should not be construed as legal advice for any particular facts or circumstances. Note that this sample presents an array of (often mutually exclusive) options with respect to particular deal provisions.**

## **MANAGEMENT RIGHTS LETTER**

## ***Preliminary Note***

*The assets of a pension plan subject to the Employee Retirement Security Act of 1974 (“ERISA”) must be held in trust. Moreover, the persons responsible for managing those assets have significant fiduciary duties under ERISA and cannot engage in certain transactions prohibited by ERISA. If a pension plan covered by ERISA (an “ERISA Plan”) invests in a venture fund, then all of the fund’s assets—such as its investments in portfolio companies—are treated as assets of the ERISA Plan, absent an exemption. As a result, the trust requirement applies, the managing partner of the fund is treated as an ERISA fiduciary, and the fund must comply with the rules regarding prohibited transactions.*

*The U.S. Department of Labor, which is charged with administering ERISA, has issued regulations that contain certain exemptions from the plan assets rules. Under one exemption, a venture fund is not deemed to hold ERISA plan assets if it qualifies as a venture capital operating company (a “VCOC”). To qualify as a VCOC, the fund must have at least 50% of its assets invested in venture capital investments. An investment in a portfolio company qualifies as a “venture capital investment” if the fund obtains certain management rights with respect to the portfolio company. “Management rights,” in turn, are defined as contractual rights running directly from the portfolio company to the fund that give the fund the right to participate substantially in, or substantially influence the conduct of, the management of the portfolio company. In addition to obtaining management rights, the fund is also required to actually exercise its management rights with respect to one or more of its portfolio companies every year.*

*In order to build a case for an exemption from the ERISA Plan asset rules, a venture fund will generally ask each of its portfolio companies to sign a management rights letter in connection with the fund’s initial investment. An example of such a letter follows.*

**[PORTFOLIO COMPANY LETTERHEAD]**

[Investor]

Re: Management Rights

Ladies and Gentlemen:

This letter will confirm our agreement that pursuant to and effective as of your purchase of [ ] shares of Series [ ] Preferred Stock of [ ] (the “**Company**”), [Investor Name] (the “**Investor**”) shall be entitled to the following contractual management rights, in addition to any rights to non-public financial information, inspection rights, and other rights specifically provided to all investors in the current financing:

1. If Investor is not represented on Company’s Board of Directors, Investor shall be entitled to consult with and advise management of the Company on significant business issues, including management’s proposed annual operating plans, and management will meet with Investor regularly during each year at the Company’s facilities at mutually agreeable times for such consultation and advice and to review progress in achieving said plans.

2. Investor may examine the books and records of the Company and inspect its facilities and may request information at reasonable times and intervals concerning the general status of the Company’s financial condition and operations, provided that access to highly confidential proprietary information and facilities need not be provided.

3. If Investor is not represented on the Company’s Board of Directors, the Company shall, concurrently with delivery to the Board of Directors, give a representative of Investor copies of all notices, minutes, consents and other material that the Company provides to its directors, except that the representative may be excluded from access to any material or meeting or portion thereof if the Board of Directors determines in good faith, upon advice of counsel, that such exclusion is reasonably necessary to preserve the attorney-client privilege, to protect highly confidential proprietary information, or for other similar reasons. Upon reasonable notice and at a scheduled meeting of the Board or such other time, if any, as the Board may determine in its sole discretion, such representative may address the Board with respect to Investor’s concerns regarding significant business issues facing the Company.

Investor agrees that any confidential information provided to or learned by it in connection with its rights under this letter shall be subject to the confidentiality provisions set forth in that certain Investors’ Rights Agreement of even date herewith by and among the Company, the Investor and other investors.<sup>1</sup>

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<sup>1</sup> If for some reason the Investor is not a party to the Investors’ Rights Agreement, you will need to copy the confidentiality provisions from the Investors’ Rights Agreement here.

The rights described herein shall terminate and be of no further force or effect upon (a) such time as no shares of the Company's stock are held by the Investor or its affiliates; (b) the consummation of the sale of the Company's securities pursuant to a registration statement filed by the Company under the Securities Act of 1933, as amended, in connection with the firm commitment underwritten offering of its securities to the general public or (c) the consummation of a merger or consolidation of the Company that is effected (i) for independent business reasons unrelated to extinguishing such rights and (ii) for purposes other than (A) the reincorporation of the Company in a different state or (B) the formation of a holding company that will be owned exclusively by the Company's stockholders and will hold all of the outstanding shares of capital stock of the Company's successor. The confidentiality obligations referenced herein will survive any such termination.

Very truly yours,

Agreed and Accepted:

**[INVESTOR]**

**[COMPANY]**

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

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## **MODEL INDEMNIFICATION AGREEMENT**

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## INTRODUCTION

*This agreement can be used for both officers and directors of the corporation. In some cases, a director will serve as a nominee of one or a group of investors (e.g., an individual venture capitalist serving as a nominee of a venture capital fund). Some venture capital funds will request that the fund, and not just their director representative, be covered by the indemnification agreement. Often that takes the form of indemnification rights covering liability arising by virtue of "corporate status" (where the investor is acting as an agent of the corporation). See *Fasciana v. Electronic Data Systems*, No. 19753 (Del. Ch. Feb. 27, 2003). To the extent an venture capital fund seeks indemnification for the fund itself, we have provided bracketed language in Section 1(d) for the draftsman to consider. The working group has not taken a position as to whether investor indemnification is "market."*

*Section 145 of the Delaware General Corporation Law ("Section 145") is the statutory authority for indemnification of directors, officers, employees and agents of the corporation. Section 145(a) permits (but does not require) indemnification of expenses (including attorneys' fees) as well as judgments and amounts paid in settlement in third-party actions (i.e., actions not brought by or in the right of the corporation) if the applicable standard is met. Section 145(b) permits (but does not require) indemnification of expenses (including attorneys' fees) but not judgments and amounts paid in settlement in derivative actions (i.e., actions brought by or in the right of the corporation) if the applicable standard is met. Thus, Section 145 draws a basic distinction between third-party and derivative actions. Section 145(c) requires indemnification of expenses (including attorneys' fees) if the indemnitee is successful on the merits or otherwise in a proceeding referred to in Section 145(a) or (b). Section 145(d) sets forth requirements for determining whether indemnification is permitted under Section 145(a) or (b). Section 145(e) permits advancement of expenses before final disposition of a proceeding subject to certain conditions. Section 145(f) provides that the statutory rights and procedures regarding indemnification are not exclusive, thus permitting indemnification under bylaws, agreements and other circumstances beyond the limits specified in Section 145. Section 145(g) allows a corporation to obtain directors' and officers' liability insurance ("D&O insurance"). Sections 145(h) through (k) address various other aspects of indemnification, including provisions relating to survivorship of the obligations of the indemnifying corporation, survivorship of rights to indemnification upon ceasing to be a director, officer, employee or agent and the exclusive jurisdiction of the Delaware Court of Chancery over indemnification proceedings.*

*Section 102(b)(7) of the Delaware General Corporation Law is the other relevant statutory authority relating to the protection of directors from monetary liability. Section 102(b)(7) allows inclusion of a provision in the certificate of incorporation that eliminates or limits (i.e., caps) the personal liability of directors to the corporation or its stockholders for monetary damages for breach of fiduciary duty. The statute, however, prohibits limitations on director liability (i) for breach of a director's duty of loyalty, (ii) for acts or omissions not in good faith or involving intentional misconduct or knowing violation of law, (iii) for willful or negligent conduct in paying dividends or repurchasing stock out of other than lawfully available funds, or (iv) for any transaction from which a director derives an improper personal benefit. In essence, Section*

*102(b)(7) allows a corporation to protect its directors from monetary liability for duty of care violations*

*As noted above, Section 145(f) provides that statutory indemnification rights are not exclusive of indemnification rights that may be provided by a bylaw provision, agreement or otherwise. As discussed below, although Section 145(f) could be read broadly to allow a corporation to grant by contract indemnification rights beyond those permitted by Section 145, cases and commentators suggest that contractual indemnification rights may be held unenforceable if they violate other statutes (including Section 145), court decisions or public policy. As a result, the enforceability of contracts that purport to grant indemnification rights beyond those permitted by Section 145 is at best unclear. (For further discussion, see comment under Section 2 below.)*

*An indemnification agreement may serve several purposes. First, and most importantly, it may provide more secure protection than a provision in a certificate of incorporation or bylaw because it cannot be amended without the approval of the indemnitee. Second, it can be used to make mandatory indemnification that is permissive under Section 145, to specify various procedures and presumptions that make indemnification more favorable to the indemnitee than is provided by Section 145 and to perhaps provide for indemnification rights that go beyond those that are expressly provided by Section 145. While such provisions could also be included in the Certificate of Incorporation or bylaws, an agreement permits different rights to be granted to specific directors, officers, employees and agents, rather than in a one size fits all approach.*

*Some companies choose to provide mandatory indemnification for directors (i.e., the company is required to indemnify a director if the applicable conditions are met) and discretionary indemnification for officers (i.e., indemnification is at the discretion of the company even if the applicable conditions are met). With respect to indemnification of directors, as discussed in the comment under Section 6(b), there may be no disinterested directors to consider approval of discretionary indemnification for directors. Accordingly, absent mandatory indemnification a board decision to indemnify itself may not be subject to the court deference under the business judgment rule. With respect to indemnification of officers, there may be situations (e.g., termination of employment, sexual harassment) where mandatory indemnification of officers would expose the Company to the possibility of funding the defense of litigation either brought by the Company or in which the Company wants to distance itself from the activities of the officer in question. Care should be taken to anticipate such situations.*

*Also note that if the company decides to indemnify directors but not officers, the indemnification agreement should make it clear that an employee director is indemnified only in his or her capacity as a director.*

*Section 145(g) specifically authorizes a corporation to obtain D&O insurance for directors and officers for liability asserted against them in such capacity or arising out of such status whether or not the corporation has the power to indemnify such persons against such liability under Section 145.*

*D&O insurance coverage is important for several reasons. First, even though indemnification may be permitted under Section 145, the corporation may be unwilling or unable to indemnify the individual. The former situation may arise after a change in corporate control where the corporation is unwilling to indemnify the individual. This may be the case, for example, if the director is the subject of litigation resulting from efforts to prevent the change in control.*

*Alternative, a corporation may be unable to provide indemnification because it is insolvent. Under Chapter 11 of the Bankruptcy Code, for example, indemnification claims by directors or officers would generally be treated as unsecured claims payable only to the extent that other unsecured claims are payable as part of an approved plan of reorganization.*

*Second, D&O insurance may insure against liabilities where indemnification is not allowed under Section 145. This occurs most frequently in the context of derivative actions and securities law actions. In particular, Section 145(g) permits a corporation to obtain insurance for (i) judgments or amounts paid in settlement in derivative actions and (ii) for expenses incurred when a director has been adjudged liable in some respects, even though indemnification under such circumstances would not be allowed under Section 145(b). In addition, a D&O insurance policy may insure against liabilities under the Securities Act of 1933, as amended (the “1933 Act”) and the Securities Exchange Act of 1934, as amended (the “1934 Act”), even though the Securities and Exchange Commission (“SEC”) has taken the position that indemnification for liabilities under Section 11 of the 1933 Act are against public policy and courts have held that indemnification for violations of the 1933 and the 1934 Act are contrary to the public policy in certain circumstances. (See comment under Section 1(a) of the Agreement.) As a result, D&O insurance may be particularly important for publicly held companies where there is greater risk of liability for derivative actions and securities law claims.*

*However, D&O insurance policies generally contain a number of qualifications and limitations that narrow the scope of coverage. In particular, D&O insurance coverage is limited by applicable insurance law as well as public policy considerations. In addition, D&O insurance policies generally exclude certain conduct from coverage, including short-swing profit liability under Section 16(b) of the 1934 Act, unauthorized remuneration, personal profit to which the insured individual is not legally entitled, claims arising out of contests for corporate control and claims brought by corporations against their own directors and officers.*



## INDEMNIFICATION AGREEMENT

THIS INDEMNIFICATION AGREEMENT (the “**Agreement**”) is made and entered into as of [\_\_\_\_\_], 200[ ] between [CORPORATION], a Delaware corporation (the “**Company**”), and [name] (“**Indemnitee**”).

WITNESSETH THAT:

WHEREAS, highly competent persons have become more reluctant to serve corporations as [directors] [officers] or in other capacities unless they are provided with adequate protection through insurance or adequate indemnification against inordinate risks of claims and actions against them arising out of their service to and activities on behalf of the corporation;

WHEREAS, the Board of Directors of the Company (the “**Board**”) has determined that, in order to attract and retain qualified individuals, the Company will attempt to maintain on an ongoing basis, at its sole expense, liability insurance to protect persons serving the Company and its subsidiaries from certain liabilities. Although the furnishing of such insurance has been a customary and widespread practice among United States-based corporations and other business enterprises, the Company believes that, given current market conditions and trends, such insurance may be available to it in the future only at higher premiums and with more exclusions. At the same time, directors, officers, and other persons in service to corporations or business enterprises are being increasingly subjected to expensive and time-consuming litigation relating to, among other things, matters that traditionally would have been brought only against the Company or business enterprise itself. [The [By-laws] [and] [Certificate of Incorporation] of the Company require indemnification of the officers and directors of the Company.] Indemnitee may also be entitled to indemnification pursuant to the General Corporation Law of the State of Delaware (“**DGCL**”). The [By-laws] [and] [Certificate of Incorporation] and the DGCL expressly provide that the indemnification provisions set forth therein are not exclusive, and thereby contemplate that contracts may be entered into between the Company and members of the Board, officers and other persons with respect to indemnification;

WHEREAS, the uncertainties relating to such insurance and to indemnification have increased the difficulty of attracting and retaining such persons;

WHEREAS, the Board has determined that the increased difficulty in attracting and retaining such persons is detrimental to the best interests of the Company's stockholders and that the Company should act to assure such persons that there will be increased certainty of such protection in the future;

WHEREAS, it is reasonable, prudent and necessary for the Company contractually to obligate itself to indemnify, and to advance expenses on behalf of, such persons to the fullest extent permitted by applicable law so that they will serve or continue to serve the Company free from undue concern that they will not be so indemnified;

WHEREAS, this Agreement is a supplement to and in furtherance of the [By-laws] [and] [Certificate of Incorporation] of the Company and any resolutions adopted pursuant thereto, and shall not be deemed a substitute therefor, nor to diminish or abrogate any rights of Indemnitee thereunder; and

WHEREAS, Indemnitee does not regard the protection available under the Company's [By-laws] [and] [Certificate of Incorporation] and insurance as adequate in the present circumstances, and may not be willing to serve as an officer or director without adequate protection, and the Company desires Indemnitee to serve in such capacity. Indemnitee is willing to serve, continue to serve and to take on additional service for or on behalf of the Company on the condition that he be so indemnified; and

WHEREAS, Indemnitee has certain rights to indemnification and/or insurance provided by [name of fund/sponsor] which Indemnitee and [name of fund/sponsor] intend to be secondary to the primary obligation of the Company to indemnify Indemnitee as provided herein, with the Company's acknowledgement and agreement to the foregoing being a material condition to Indemnitee's willingness to serve on the Board.

NOW, THEREFORE, in consideration of Indemnitee's agreement to serve as an [officer] [director] from and after the date hereof, the parties hereto agree as follows:

1. Indemnity of Indemnitee. The Company hereby agrees to hold harmless and indemnify Indemnitee to the fullest extent permitted by law, as such may be amended from time to time. In furtherance of the foregoing indemnification, and without limiting the generality thereof.

*[Comment: Sections 1 and 2 of the agreement contain the basic indemnification obligations of the agreement. Section 1 provides for indemnification that essentially tracks Section 145, while Section 2 provides for broader indemnification (e.g., by providing for indemnification of judgments, penalties and amounts paid in settlement of derivative actions). The overlap in coverage of the two sections is intentional. Indemnification under Section 1 is designed to be available even if a Delaware court does not allow indemnification under Section 2 in a particular instance.]*

*Section 1 essentially requires indemnification to the fullest extent permitted or required under Section 145. Thus, Section 1 makes mandatory indemnification that is permissive under Sections 145(a) and (b). Note that Section 1 does not make mandatory a determination under Section 145(d) that the applicable standard of conduct has been satisfied. Therefore, even though mandatory, indemnification under Sections 1(a) and (b) is subject to a determination under Section 145(d) and Section 6(b) that the applicable standard has been satisfied.]*

(a) Proceedings Other Than Proceedings by or in the Right of the Company. Indemnitee shall be entitled to the rights of indemnification provided in this Section 1(a) if, by reason of his Corporate Status (as hereinafter defined), the Indemnitee is, or is threatened to be made, a party to or participant in any Proceeding (as hereinafter defined) other than a Proceeding by or in the right of the Company. Pursuant to this Section 1(a), Indemnitee shall be indemnified against all Expenses (as hereinafter defined), judgments, penalties, fines and amounts paid in settlement actually and reasonably incurred by him, or on his behalf, in connection with such Proceeding or any claim, issue or matter therein, if the Indemnitee acted in good faith and in a manner the Indemnitee reasonably believed to be in or not opposed to the best interests of the Company, and with respect to any criminal Proceeding, had no reasonable cause to believe the Indemnitee's conduct was unlawful.

*[Comment: Section 145(a) permits indemnification of officers, directors, employees or agents for attorneys' fees and other expenses as well as for judgments or amounts paid in settlement in civil cases. As noted above, Section 145(a) applies only to third-party actions and not to derivative actions. The person seeking indemnification must have acted in good faith and in a manner reasonably believed to be in the best interests of, or not opposed to the best interests of, the corporation in connection with the claim made against such person. In criminal cases, the indemnitee may be indemnified for fines and costs provided that, in addition to the foregoing standard of conduct, the indemnitee must not have had reasonable cause to believe that indemnitee's conduct was unlawful. Section 1(a) of the Agreement essentially tracks Section 145(a), except that it makes indemnification mandatory rather than permissive.]*

*The distinction between third-party and derivative actions is critical to understanding the statutory framework. A derivative action is an action brought by a stockholder on behalf of the corporation to redress a wrong done by someone to the corporation. Therefore, the derivative action must be based upon an alleged injury to the corporation which caused harm to the corporation itself, and to the stockholder only derivatively through their ownership of stock in the corporation. In some cases, there can be uncertainty as to whether a particular action constitutes a derivative action (i.e., to address a breach of a duty to the corporation) or a third-party action (i.e., a direct harm to the third party plaintiff).*

*Proceedings that allege breach of fiduciary duties of officers and directors to the corporation often are derivative actions, and actions against officers and directors for violations of federal securities laws (e.g., actions alleging a violation of Section 11 of the 1933 Act in connection with a public offering of securities or Rule 10b-5 in connection with an offer or sale of securities) would normally be third-party actions. Therefore, absent public policy concerns, an action against a director or officer alleging federal securities law liability would fall within the relatively favorable third-party indemnification provisions of Section 145(a). As noted above, Section 145(a) permits indemnity even if the director or officer loses the case, so long as the indemnitee meets the applicable standard following a determination pursuant to Section 145(d).*

*The SEC has taken the position, however, that even if a director or officer meets the relevant standard of conduct for indemnification under corporate law, corporate indemnification for liabilities arising under the 1933 Act is against public policy. In addition, courts have held that indemnification for violations of either the 1933 Act or the 1934 Act is contrary to public policy, at least for violations based upon culpable behavior greater than ordinary negligence.*

*These public policy limitations may apply to a variety of sources of liability under the 1933 Act and 1934 Act, including (i) Section 12 of the 1933 Act for offers and sales of securities, (ii) Rule 10b-5 of the 1934 Act for violation of antifraud provisions, (iii) Section 16(b) of the 1934 Act for short-swing trading profits, (iv) Section 15 of the 1933 Act and Section 20 of the 1934 Act for liability of control persons and Section 18 of the 1934 Act for misleading statements. Thus, even*

*though otherwise permissible under Section 145(a), indemnification may be contrary to the public policy underlying the federal securities laws and therefore unenforceable. These potential limitations on indemnity underscore the importance of having separate D&O Insurance coverage.]*

(b) Proceedings by or in the Right of the Company. Indemnitee shall be entitled to the rights of indemnification provided in this Section 1(b) if, by reason of his Corporate Status, the Indemnitee is, or is threatened to be made, a party to or participant in any Proceeding brought by or in the right of the Company. Pursuant to this Section 1(b), Indemnitee shall be indemnified against all Expenses actually and reasonably incurred by the Indemnitee, or on the Indemnitee's behalf, in connection with such Proceeding if the Indemnitee acted in good faith and in a manner the Indemnitee reasonably believed to be in or not opposed to the best interests of the Company; provided, however, if applicable law so provides, no indemnification against such Expenses shall be made in respect of any claim, issue or matter in such Proceeding as to which Indemnitee shall have been adjudged to be liable to the Company unless and to the extent that the Court of Chancery of the State of Delaware shall determine that such indemnification may be made.

*[Comment: Section 145(b) permits indemnification of directors, officers, employees and agents for attorneys' fees and other expenses in derivative actions but not for judgments, fines or amounts paid in settlement of such actions. However, in a proceeding where the individual is adjudged to be liable to the corporation, Section 145(b) does not permit indemnification even for expenses unless and to the extent that an appropriate court determines that, in view of all the circumstances, the individual is fairly and reasonably entitled to indemnification for such expenses. Thus, indemnification for derivative actions is significantly more limited than for third-party actions. The rationale for this distinction is that any liability in a derivative action is to make the corporation (on whose behalf the action was brought) whole for harm it suffered, and the corporation would not receive any benefit by indemnifying an individual against such liability. In effect, the corporation would be returning funds to the person liable to pay them. As with Section 1(a), Section 1(b) essentially tracks Section 145(b), except that it makes indemnification mandatory rather than permissible.]*

*Note that by eliminating or limiting a director's exposure to financial liability for breaches of certain classes of fiduciary duties, Section 102(b)(7) may reduce exposure for claims that would otherwise result in derivative actions and thereby overcome some of the limitations on indemnification in Section 145(b).]*

(c) Indemnification for Expenses of a Party Who is Wholly or Partly Successful. Notwithstanding any other provision of this Agreement, to the extent that Indemnitee is, by reason of his Corporate Status, a party to and is successful, on the merits or otherwise, in any Proceeding, he shall be indemnified to the maximum extent permitted by law, as such may be amended from time to time, against all Expenses actually and reasonably incurred by him or on his behalf in connection therewith. If Indemnitee is not wholly successful in such Proceeding but is successful, on the merits or otherwise, as to one or more but less than all claims, issues or matters in such Proceeding, the Company shall indemnify Indemnitee against all Expenses actually and reasonably incurred by him or on his behalf in connection with each successfully resolved claim, issue or matter. For purposes of this Section and without

limitation, the termination of any claim, issue or matter in such a Proceeding by dismissal, with or without prejudice, shall be deemed to be a successful result as to such claim, issue or matter.

*[Comment: Section 145(c) requires the corporation to indemnify a director or officer for attorney's fees and other expenses actually and reasonably incurred in connection with a proceeding referred to in Sections 145(a) or (b) to the extent that the indemnitee is "successful on the merits or otherwise." In other words, an indemnitee is entitled to indemnification for reasonable expenses to the extent successful on the merits, even if the indemnitee is successful for "technical" reasons. Section 1(c) essentially tracks Section 145(c), except that it explicitly addresses the situation where the indemnitee is partially successful by providing that an indemnitee is entitled to indemnification for expenses incurred with respect to successfully resolved claims.]*

[(d) Indemnification of Appointing Stockholder. [If (i) Indemnitee is or was affiliated with one or more venture capital funds that has invested in the Company (an "Appointing Stockholder"), and (ii) the Appointing Stockholder is, or is threatened to be made, a party to or a participant in any Proceeding, and (iii) the Appointing Stockholder's involvement in the Proceeding (A) arises primarily out of, or relates to, any action taken by the Company that was approved by the Company's Board and (B) arises out of facts or circumstances that are the same or substantially similar to the facts and circumstances that form the basis of claims that have been, could have been or could be brought against the Indemnitee in a Proceeding, regardless of whether the legal basis of the claims against the Indemnitee and the Appointing Stockholder are the same or similar, then the Appointing Stockholder shall be entitled to all of the indemnification rights and remedies under this Agreement pursuant to this Agreement as if the Appointing Stockholder were the Indemnitee. ]

[If (i) Indemnitee is or was affiliated with one or more venture capital funds that has invested in the Company (an "**Appointing Stockholder**"), (ii) the Appointing Stockholder is, or is threatened to be made, a party to or a participant in any Proceeding, and (iii) the Appointing Stockholder's involvement in the Proceeding results from any claim based on the Indemnitee's service to the Company as a director or other fiduciary of the Company, the Appointing Stockholder will be entitled to indemnification hereunder for Expenses to the same extent as Indemnitee, and the terms of this Agreement as they relate to procedures for indemnification of Indemnitee and advancement of Expenses shall apply to any such indemnification of Appointing Stockholder.]

[If (i) Indemnitee is or was affiliated with one or more venture capital funds that has invested in the Company (an "**Appointing Stockholder**"), and (ii) the Appointing Stockholder is, or is threatened to be made, a party to or a participant in any Proceeding relating to or arising by reason of Appointing Stockholder's position as a stockholder of, or lender to, the Company, or Appointing Stockholder's appointment of or affiliation with Indemnitee or any other director, including without limitation any alleged misappropriation of a Company asset or corporate opportunity, any claim of misappropriation or infringement of intellectual property relating to the Company, any alleged false or misleading statement or omission made by the Company (or on its behalf) or its employees or agents, or any allegation of inappropriate control or influence over the Company or its Board members, officers, equity holders or debt holders, then the Appointing Stockholder will be entitled to indemnification hereunder for Expenses to the same extent as Indemnitee, and the terms of this Agreement as they relate to procedures for indemnification of

Indemnitee and advancement of Expenses shall apply to any such indemnification of Appointing Stockholder.]

*[The rights provided to the Appointing Stockholder under this Section 2 shall (i) be suspended during any period during which the Appointing Stockholder does not have a representative on the Company's Board and (ii) terminate on an initial public offering of the Company's Common Stock; provided, however, that in the event of any such suspension or termination, the Appointing Stockholder's rights to indemnification will not be suspended or terminated with respect to any Proceeding based in whole or in part on facts and circumstances occurring at any time prior to such suspension or termination regardless of whether the Proceeding arises before or after such suspension or termination.] The Company and Indemnitee agree that the Appointing Stockholder is an express third party beneficiary of the terms of this Section 1(d).]*

*[The above language presents three alternatives, with the third providing the broadest indemnification of the venture capital fund.]*

2. Additional Indemnity. In addition to, and without regard to any limitations on, the indemnification provided for in Section 1 of this Agreement, the Company shall and hereby does indemnify and hold harmless Indemnitee against all Expenses, judgments, penalties, fines and amounts paid in settlement actually and reasonably incurred by him or on his behalf if, by reason of his Corporate Status, he is, or is threatened to be made, a party to or participant in any Proceeding (including a Proceeding by or in the right of the Company), including, without limitation, all liability arising out of the negligence or active or passive wrongdoing of Indemnitee. The only limitation that shall exist upon the Company's obligations pursuant to this Agreement shall be that the Company shall not be obligated to make any payment to Indemnitee that is finally determined (under the procedures, and subject to the presumptions, set forth in Sections 6 and 7 hereof) to be unlawful.

*[Comment: Section 2 provides for additional indemnification beyond the scope of indemnification provided by Section 1. For example, Section 2 provides for mandatory indemnification of judgments, penalties, fines and amounts paid in settlement of derivative actions. The only limitation is that no indemnification is required to the extent that it is finally determined to be unlawful in accordance with procedures and presumptions set forth in the agreement.]*

*The scope of additional protection provided by Section 2 is unclear. As noted above, although Section 145(f) expressly permits contractual indemnification rights beyond the statutory rights provided for in Section 145, the enforceability of such contractual rights may be limited by statute, court decision and public policy.*

*Contractual indemnification rights beyond Section 145 can be classified into different categories that may be helpful in assessing their enforceability. Some contractual rights make indemnification which is permissive under Section 145 mandatory (e.g., a provision requiring indemnification relating to third-party actions to the extent permitted under Section 145(a)). Other contractual rights attempt to clarify or supplement statutory rights without significantly altering*

*those rights (e.g., a procedural requirement that a corporation advance expenses within a certain period of time following a proper undertaking from the indemnitee or defining “independent legal counsel” for purposes of making a determination under Section 145(d)). Still other contractual rights specify policies, procedures and presumptions that have the purpose or effect of enhancing indemnification rights beyond the provisions of Section 145 (e.g., a presumption that an individual has met the applicable standard of care or a provision that a determination that the applicable standard of care is deemed to be met if no such determination is made within a specified period). Finally, some contractual indemnification rights appear to be inconsistent with the limits on indemnification specified in Section 145 (e.g., a provision indemnifying for judgments in derivative actions even if the indemnitee has engaged in clearly culpable behavior).*

*One commentator has noted: “There is no case which spells out the precise perimeters of the extent to which an indemnification agreement . . . may go in providing indemnification rights . . . under Section 145(f) . . . Although there is no case law on point, it is probable that a Delaware court would not allow indemnification under a . . . contract when the proposed indemnification is prohibited by law or public policy. . . . Nevertheless, Section 145(f) does provide support for wide-ranging agreements which broaden or enlarge upon indemnification rights granted in the various other subsections of Section 145, although provisions in such a[n] . . . agreement which are contrary to limitations or prohibitions set forth in other subsections may be held unenforceable if they violate other statutes, court decisions or public policies. . . . For example, because of the limitations of Section 145(b), a corporation may not be able to indemnify under the authority of Section 145(f) for judgments or amounts paid in settlements in derivative suits. . . . On the other hand, Section 145(f) may authorize the adoption of various procedures and presumptions to make the process of indemnification more favorable to the indemnitee without violating that statute.” See Balotti and Finkelstein, *Delaware Law of Corporation and Business Organizations*, § 4.16 at 4-345 to 4-350.*

*Sometimes a contract providing for indemnification beyond Section 145 will itself contain limitations on the scope of additional indemnification. These limitations might include prohibitions on indemnification for (i) violations of insider trading laws such as Section 16(b) of the 1934 Act, (ii) conduct that is determined to be knowingly fraudulent or deliberately dishonest or to constitute willful misconduct, (iii) actions brought by the corporation, (iv) actions brought by the indemnitee without board approval and (v) actions relating to proxy contests in opposition to the board. See Section 9 below.]*

### 3. Contribution.

*[Comment: The provisions regarding contribution are primarily intended to provide an alternative means of protecting individuals from liability for some types of federal securities law violations where indemnification is unenforceable for public policy reasons. For example, Section 11(f) of the 1933 Act explicitly recognizes contribution in cases where one or more persons are or may be*

*subject to the same liability under Section 11, even though the SEC takes the position that indemnification for Section 11 violations is contrary to public policy.]*

(a) Whether or not the indemnification provided in Sections 1 and 2 hereof is available, in respect of any threatened, pending or completed action, suit or proceeding in which the Company is jointly liable with Indemnitee (or would be if joined in such action, suit or proceeding), the Company shall pay, in the first instance, the entire amount of any judgment or settlement of such action, suit or proceeding without requiring Indemnitee to contribute to such payment and the Company hereby waives and relinquishes any right of contribution it may have against Indemnitee. The Company shall not enter into any settlement of any action, suit or proceeding in which the Company is jointly liable with Indemnitee (or would be if joined in such action, suit or proceeding) unless such settlement provides for a full and final release of all claims asserted against Indemnitee.

*[Comment: Section 3(a), in effect, provides that where the corporation and the individual are jointly liable (or if joined, would be), the corporation shall contribute 100% of the liability, and the individual would not be required to contribute anything. Section 3(a) also prohibits the corporation from entering into any settlement that does not completely release the individual.]*

(b) Without diminishing or impairing the obligations of the Company set forth in the preceding subparagraph, if, for any reason, Indemnitee shall elect or be required to pay all or any portion of any judgment or settlement in any threatened, pending or completed action, suit or proceeding in which the Company is jointly liable with Indemnitee (or would be if joined in such action, suit or proceeding), the Company shall contribute to the amount of Expenses, judgments, fines and amounts paid in settlement actually and reasonably incurred and paid or payable by Indemnitee in proportion to the relative benefits received by the Company and all officers, directors or employees of the Company, other than Indemnitee, who are jointly liable with Indemnitee (or would be if joined in such action, suit or proceeding), on the one hand, and Indemnitee, on the other hand, from the transaction or events from which such action, suit or proceeding arose; provided, however, that the proportion determined on the basis of relative benefit may, to the extent necessary to conform to law, be further adjusted by reference to the relative fault of the Company and all officers, directors or employees of the Company other than Indemnitee who are jointly liable with Indemnitee (or would be if joined in such action, suit or proceeding), on the one hand, and Indemnitee, on the other hand, in connection with the transaction or events that resulted in such expenses, judgments, fines or settlement amounts, as well as any other equitable considerations which applicable law may require to be considered. The relative fault of the Company and all officers, directors or employees of the Company, other than Indemnitee, who are jointly liable with Indemnitee (or would be if joined in such action, suit or proceeding), on the one hand, and Indemnitee, on the other hand, shall be determined by reference to, among other things, the degree to which their actions were motivated by intent to gain personal profit or advantage, the degree to which their liability is primary or secondary and the degree to which their conduct is active or passive.

*[Comment: Section 3(b) provides an alternative method of allocating the amount contributed by the corporation and the individual in the event that the method of allocation in Section 3(a) (i.e., 100% payment by the corporation) is not enforceable. In particular, Section 3(b) provides for allocation based on the*



*relative benefits received from the transaction giving rise to liability, and if required to conform to law, the relative fault of the parties.]*

(c) The Company hereby agrees to fully indemnify and hold Indemnitee harmless from any claims of contribution which may be brought by officers, directors or employees of the Company, other than Indemnitee, who may be jointly liable with Indemnitee.

*[Comment: Section 3(c) attempts to indemnify the indemnitee against contribution sought from other third parties.]*

(d) To the fullest extent permissible under applicable law, if the indemnification provided for in this Agreement is unavailable to Indemnitee for any reason whatsoever, the Company, in lieu of indemnifying Indemnitee, shall contribute to the amount incurred by Indemnitee, whether for judgments, fines, penalties, excise taxes, amounts paid or to be paid in settlement and/or for Expenses, in connection with any claim relating to an indemnifiable event under this Agreement, in such proportion as is deemed fair and reasonable in light of all of the circumstances of such Proceeding in order to reflect (i) the relative benefits received by the Company and Indemnitee as a result of the event(s) and/or transaction(s) giving cause to such Proceeding; and/or (ii) the relative fault of the Company (and its directors, officers, employees and agents) and Indemnitee in connection with such event(s) and/or transaction(s).

*[Comment: Section 3(d) provides for contribution by the Company even if the Company is not held jointly liable based on the relative benefit to the Company of the conduct of the indemnitee giving rise to the loss or expenses incurred by the indemnitee and /or the relative fault of the Company and the indemnitee in connection with the matter in question.]*

4. Indemnification for Expenses of a Witness. Notwithstanding any other provision of this Agreement, to the extent that Indemnitee is, by reason of his Corporate Status, a witness, or is made (or asked) to respond to discovery requests, in any Proceeding to which Indemnitee is not a party, he shall be indemnified against all Expenses actually and reasonably incurred by him or on his behalf in connection therewith.

*[Comment: Section 4 indemnifies individuals for costs and expenses in serving as a witness in any proceeding relating to such person's service to the corporation.]*

5. Advancement of Expenses. Notwithstanding any other provision of this Agreement, the Company shall advance all Expenses incurred by or on behalf of Indemnitee in connection with any Proceeding by reason of Indemnitee's Corporate Status within thirty (30) days after the receipt by the Company of a statement or statements from Indemnitee requesting such advance or advances from time to time, whether prior to or after final disposition of such Proceeding. Such statement or statements shall reasonably evidence the Expenses incurred by Indemnitee and shall include or be preceded or accompanied by a written undertaking by or on behalf of Indemnitee to repay any Expenses advanced if it shall ultimately be determined that Indemnitee is not entitled to be indemnified against such Expenses. Any advances and undertakings to repay pursuant to this Section 5 shall be unsecured and interest free.

*[Comment: As noted above, Section 145(e) provides for the advancement of attorney's fees and other expenses to officers and directors in connection with any*

*civil, criminal, administrative or investigative proceeding. Section 145(e) conditions any advance upon receipt of an undertaking by or on behalf of such director or officer to repay such amount if it is ultimately determined that such individual is not entitled to be indemnified by the corporation.*

*Section 5 is modeled after Section 145(e), except that it makes the corporation's duty to advance expenses mandatory rather than permissive. Section 5 also supplements Section 145(e) in various respects. Section 5 requires payment within 30 days after receipt of a request for advancement (provided the request includes a statement of the expenses and an undertaking to repay any advance expenses if it is determined that the indemnitee is not entitled to indemnification against such expenses).*

6. Procedures and Presumptions for Determination of Entitlement to Indemnification. It is the intent of this Agreement to secure for Indemnitee rights of indemnity that are as favorable as may be permitted under the DGCL and public policy of the State of Delaware. Accordingly, the parties agree that the following procedures and presumptions shall apply in the event of any question as to whether Indemnitee is entitled to indemnification under this Agreement:

*[Comment: Section 6 specifies policies and procedures to be applied in determining whether an individual is entitled to indemnification under the Agreement. As with other provisions of the agreement, these policies and procedures are not specifically authorized by Section 145. As a result, the rights and procedures specified in Section 6 may be unenforceable. See the comment under Section 2 of the Agreement above. Note, however, that unlike indemnification agreements customarily entered into in financings (e.g., between the issuer and underwriters in an underwritten public offering), this Agreement (and most indemnification agreements) do not delineate defense procedures.]*

(a) To obtain indemnification under this Agreement, Indemnitee shall submit to the Company a written request, including therein or therewith such documentation and information as is reasonably available to Indemnitee and is reasonably necessary to determine whether and to what extent Indemnitee is entitled to indemnification. The Secretary of the Company shall, promptly upon receipt of such a request for indemnification, advise the Board in writing that Indemnitee has requested indemnification. Notwithstanding the foregoing, any failure of Indemnitee to provide such a request to the Company, or to provide such a request in a timely fashion, shall not relieve the Company of any liability that it may have to Indemnitee unless, and to the extent that, such failure actually and materially prejudices the interests of the Company.

(b) Upon written request by Indemnitee for indemnification pursuant to the first sentence of Section 6(a) hereof, a determination with respect to Indemnitee's entitlement thereto shall be made in the specific case by one of the following four methods, which shall be at the election of the Board: (1) by a majority vote of the disinterested directors, even though less than a quorum, (2) by a committee of disinterested directors designated by a majority vote of the disinterested directors, even though less than a quorum, (3) if there are no disinterested directors or if the disinterested directors so direct, by independent legal counsel in a written opinion to the Board, a copy of which shall be delivered to the Indemnitee, or (4) if so directed by the Board,

by the stockholders of the Company. For purposes hereof, disinterested directors are those members of the Board who are not parties to the action, suit or proceeding in respect of which indemnification is sought by Indemnitee.

*[Comment: As noted above, Section 145(e) provides that indemnification under Sections 145(a) and (b) must be authorized on a case-by-case basis (unless ordered by a court) in accordance with a statutorily mandated decision making process. The determination that must be made in each case is whether indemnification is proper in the circumstances because the indemnitee has met the applicable standard of conduct set forth Section 145(a) or (b). Such determination may be made (i) by a majority vote of the directors who are not parties to the proceeding, (ii) by a committee of such directors, (iii) by independent legal counsel in a written opinion or (iv) by the stockholders.*

*There are a number of practical problems in making a determination pursuant to Section 145(d). First, many actions that give rise to indemnification claims will be brought against all directors and therefore preclude a determination by majority vote of disinterested directors. One solution might be to appoint additional disinterested directors to make a determination, although this course of action may present its own difficulties. Second, many corporations and directors will be reluctant to use the alternative of seeking stockholder approval, particularly for publicly held corporations where the approval process would be difficult and widely publicized. Third, the term “independent legal counsel” is not defined in Section 145 or applicable case law, and even if a well-established definition existed, a number of issues would arise in rendering a required opinion should experienced counsel agree to consider doing so.*

*Section 6(b) allows the board to select the method of determination. Some agreements for public companies provide that independent counsel make the determination following a change in control (presumably on the theory that directors and stockholders after a change in control may be less inclined to act impartially) and allow the company to select the method of determination otherwise. Other agreements purport to vest this authority in the Indemnitee, but such a provision could be challenged as an unlawful delegation of the board’s responsibility to manage the business and affairs of the corporation under Section 141(a) of the DGCL.*

*For a public company where it is desired to provide that following a change of control the indemnification determination would be made by independent counsel, an example of a typical “change of control” definition follows:*

*\_\_\_. \_\_\_.A “Change in Control” shall be deemed to occur upon the earliest to occur after the date of this Agreement of any of the following events:*

*(i) Acquisition of Stock by Third Party. Any Person (as defined below) is or becomes the Beneficial Owner (as defined below), directly or indirectly, of securities of the Company representing [fifteen percent (15%)] or more of the combined*

voting power of the Company's then outstanding securities;

(ii) *Change in Board.* During any period of two (2) consecutive years (not including any period prior to the execution of this Agreement), individuals who at the beginning of such period constitute the Board, and any new director (other than a director designated by a person who has entered into an agreement with the Company to effect a transaction described in Sections \_\_ (a)(i), \_\_ (a)(iii) or \_\_ (a)(iv)) whose election by the Board or nomination for election by the Company's stockholders was approved by a vote of at least two-thirds of the directors then still in office who either were directors at the beginning of the period or whose election or nomination for election was previously so approved, cease for any reason to constitute a least a majority of the members of the Board;

(iii) *Corporate Transactions.* The effective date of a merger or consolidation of the Company with any other entity, other than a merger or consolidation which would result in the voting securities of the Company outstanding immediately prior to such merger or consolidation continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) more than 51% of the combined voting power of the voting securities of the surviving entity outstanding immediately after such merger or consolidation and with the power to elect at least a majority of the Board or other governing body of such surviving entity;

(iv) *Liquidation.* The approval by the stockholders of the Company of a complete liquidation of the Company or an agreement for the sale or disposition by the Company of all or substantially all of the Company's assets; and

(v) *Other Events.* There occurs any other event of a nature that would be required to be reported in response to Item 6(e) of Schedule 14A of Regulation 14A (or a response to any similar item on any similar schedule or form) promulgated under the Exchange Act (as defined below), whether or not the Company is then subject to such reporting requirement.

For purposes of this Section \_\_ (a), the following terms shall have the following meanings:

(A) "Exchange Act" shall mean the Securities Exchange Act of 1934, as amended.

(B) "Person" shall have the meaning as set forth in Sections 13(d) and 14(d) of the Exchange Act; provided, however, that Person shall exclude (i) the Company, (ii) any trustee or other

*fiduciary holding securities under an employee benefit plan of the Company, and (iii) any corporation owned, directly or indirectly, by the stockholders of the Company in substantially the same proportions as their ownership of stock of the Company.*

*(C) “Beneficial Owner” shall have the meaning given to such term in Rule 13d-3 under the Exchange Act; provided, however, that Beneficial Owner shall exclude any Person otherwise becoming a Beneficial Owner by reason of the stockholders of the Company approving a merger of the Company with another entity.]*

(c) If the determination of entitlement to indemnification is to be made by Independent Counsel pursuant to Section 6(b) hereof, the Independent Counsel shall be selected as provided in this Section 6(c). The Independent Counsel shall be selected by the Board. Indemnitee may, within 10 days after such written notice of selection shall have been given, deliver to the Company a written objection to such selection; provided, however, that such objection may be asserted only on the ground that the Independent Counsel so selected does not meet the requirements of “**Independent Counsel**” as defined in Section 13 of this Agreement, and the objection shall set forth with particularity the factual basis of such assertion. Absent a proper and timely objection, the person so selected shall act as Independent Counsel. If a written objection is made and substantiated, the Independent Counsel selected may not serve as Independent Counsel unless and until such objection is withdrawn or a court has determined that such objection is without merit. If, within 20 days after submission by Indemnitee of a written request for indemnification pursuant to Section 6(a) hereof, no Independent Counsel shall have been selected and not objected to, either the Company or Indemnitee may petition the Court of Chancery of the State of Delaware or other court of competent jurisdiction for resolution of any objection which shall have been made by the Indemnitee to the Company’s selection of Independent Counsel and/or for the appointment as Independent Counsel of a person selected by the court or by such other person as the court shall designate, and the person with respect to whom all objections are so resolved or the person so appointed shall act as Independent Counsel under Section 6(b) hereof. The Company shall pay any and all reasonable fees and expenses of Independent Counsel incurred by such Independent Counsel in connection with acting pursuant to Section 6(b) hereof, and the Company shall pay all reasonable fees and expenses incident to the procedures of this Section 6(c), regardless of the manner in which such Independent Counsel was selected or appointed.

*[Comment: Sections 6(c) through (g) specify procedures and presumptions that apply in making a determination of entitlement to indemnification. Section 6(c) gives the Board the right to select independent legal counsel, subject to an objection procedure. Some public company agreements vest the ability to select the Independent Counsel in the Indemnitee after a change of control; but such a provision could be challenged as an unlawful delegation of the board’s responsibility to manage the business and affairs of the corporation under Section 141(a) of the DGCL. Section 6(d) below creates a presumption that the indemnitee is entitled to indemnification, allocates the burden of proof to the party seeking to overcome the presumption and specifies an applicable standard of proof. Section 6(e), among other things, creates a presumption that the indemnitee acted in accordance with the standard of behavior required for*

*indemnification, allocates the burden of proof to the party seeking to overcome the presumption, specifies the applicable standard of proof and specifies circumstances under which the indemnitee is deemed to have acted in good faith. Section 6(f) below provides for a determination of entitlement if no determination is made by the decision-maker within 60 days after a request for determination (plus a 30 day extension right) subject to certain conditions. Section 6(g) below requires the indemnitee to cooperate with the person or persons making the determination, requires such person or persons to act reasonably and in good faith and requires the corporation to pay certain costs associated with making the determination.*

(d) In making a determination with respect to entitlement to indemnification hereunder, the person or persons or entity making such determination shall presume that Indemnitee is entitled to indemnification under this Agreement. Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence. Neither the failure of the Company (including by its directors or independent legal counsel) to have made a determination prior to the commencement of any action pursuant to this Agreement that indemnification is proper in the circumstances because Indemnitee has met the applicable standard of conduct, nor an actual determination by the Company (including by its directors or independent legal counsel) that Indemnitee has not met such applicable standard of conduct, shall be a defense to the action or create a presumption that Indemnitee has not met the applicable standard of conduct.

*[Comment: Indemnification agreements may be subject to review by state securities law administrators if the corporation's securities are registered or qualified in their state. For example, the California Department of Corporations has objected to shifting the burden of proof as provided in this Section 6(d). In one instance, a corporation was required to renegotiate indemnification agreements with its directors to eliminate a similar provision before qualifying an issuance of securities in California.]*

(e) Indemnitee shall be deemed to have acted in good faith if Indemnitee's action is based on the records or books of account of the Enterprise (as hereinafter defined), including financial statements, or on information supplied to Indemnitee by the officers of the Enterprise in the course of their duties, or on the advice of legal counsel for the Enterprise or on information or records given or reports made to the Enterprise by an independent certified public accountant or by an appraiser or other expert selected with reasonable care by the Enterprise. In addition, the knowledge and/or actions, or failure to act, of any director, officer, agent or employee of the Enterprise shall not be imputed to Indemnitee for purposes of determining the right to indemnification under this Agreement. Whether or not the foregoing provisions of this Section 6(e) are satisfied, it shall in any event be presumed that Indemnitee has at all times acted in good faith and in a manner he reasonably believed to be in or not opposed to the best interests of the Company. Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence.

(f) If the person, persons or entity empowered or selected under Section 6 to determine whether Indemnitee is entitled to indemnification shall not have made a determination within sixty (60) days after receipt by the Company of the request therefor, the requisite determination of entitlement to indemnification shall be deemed to have been made and

Indemnitee shall be entitled to such indemnification absent (i) a misstatement by Indemnitee of a material fact, or an omission of a material fact necessary to make Indemnitee's statement not materially misleading, in connection with the request for indemnification, or (ii) a prohibition of such indemnification under applicable law; provided, however, that such 60-day period may be extended for a reasonable time, not to exceed an additional thirty (30) days, if the person, persons or entity making such determination with respect to entitlement to indemnification in good faith requires such additional time to obtain or evaluate documentation and/or information relating thereto; and provided, further, that the foregoing provisions of this Section 6(g) shall not apply if the determination of entitlement to indemnification is to be made by the stockholders pursuant to Section 6(b) of this Agreement and if (A) within fifteen (15) days after receipt by the Company of the request for such determination, the Board or the Disinterested Directors, if appropriate, resolve to submit such determination to the stockholders for their consideration at an annual meeting thereof to be held within seventy-five (75) days after such receipt and such determination is made thereat, or (B) a special meeting of stockholders is called within fifteen (15) days after such receipt for the purpose of making such determination, such meeting is held for such purpose within sixty (60) days after having been so called and such determination is made thereat.

(g) Indemnitee shall cooperate with the person, persons or entity making such determination with respect to Indemnitee's entitlement to indemnification, including providing to such person, persons or entity upon reasonable advance request any documentation or information which is not privileged or otherwise protected from disclosure and which is reasonably available to Indemnitee and reasonably necessary to such determination. Any Independent Counsel, member of the Board or stockholder of the Company shall act reasonably and in good faith in making a determination regarding the Indemnitee's entitlement to indemnification under this Agreement. Any costs or expenses (including attorneys' fees and disbursements) incurred by Indemnitee in so cooperating with the person, persons or entity making such determination shall be borne by the Company (irrespective of the determination as to Indemnitee's entitlement to indemnification) and the Company hereby indemnifies and agrees to hold Indemnitee harmless therefrom.

(h) The Company acknowledges that a settlement or other disposition short of final judgment may be successful if it permits a party to avoid expense, delay, distraction, disruption and uncertainty. In the event that any action, claim or proceeding to which Indemnitee is a party is resolved in any manner other than by adverse judgment against Indemnitee (including, without limitation, settlement of such action, claim or proceeding with or without payment of money or other consideration) it shall be presumed that Indemnitee has been successful on the merits or otherwise in such action, suit or proceeding. Anyone seeking to overcome this presumption shall have the burden of proof and the burden of persuasion by clear and convincing evidence.

*[Comment: Section 6(h) creates a presumption that any resolution of a claim other than by adverse judgment against the Indemnitee (including a settlement, regardless of whether money is paid) constitutes being "successful on the merits or otherwise" for purposes of Section 145(c). Section 6(h) also allocates the burden of proof to the party seeking to overcome the presumption and specifies the standard of proof in overcoming the presumption. If enforceable, this provision is particularly helpful because it would allow for mandatory indemnification pursuant to Section 145(c).]*

(i) The termination of any Proceeding or of any claim, issue or matter therein, by judgment, order, settlement or conviction, or upon a plea of nolo contendere or its equivalent, shall not (except as otherwise expressly provided in this Agreement) of itself adversely affect the right of Indemnitee to indemnification or create a presumption that Indemnitee did not act in good faith and in a manner which he reasonably believed to be in or not opposed to the best interests of the Company or, with respect to any criminal Proceeding, that Indemnitee had reasonable cause to believe that his conduct was unlawful.

## 7. Remedies of Indemnitee.

(a) In the event that (i) a determination is made pursuant to Section 6 of this Agreement that Indemnitee is not entitled to indemnification under this Agreement, (ii) advancement of Expenses is not timely made pursuant to Section 5 of this Agreement, (iii) no determination of entitlement to indemnification is made pursuant to Section 6(b) of this Agreement within 90 days after receipt by the Company of the request for indemnification, (iv) payment of indemnification is not made pursuant to this Agreement within ten (10) days after receipt by the Company of a written request therefor or (v) payment of indemnification is not made within ten (10) days after a determination has been made that Indemnitee is entitled to indemnification or such determination is deemed to have been made pursuant to Section 6 of this Agreement, Indemnitee shall be entitled to an adjudication in an appropriate court of the State of Delaware, or in any other court of competent jurisdiction, of Indemnitee's entitlement to such indemnification. Indemnitee shall commence such proceeding seeking an adjudication within 180 days following the date on which Indemnitee first has the right to commence such proceeding pursuant to this Section 7(a). The Company shall not oppose Indemnitee's right to seek any such adjudication.

*[Comment: Section 7(a) provides for a right of adjudication before a Delaware court in the event of certain adverse results under the Agreement.]*

(b) In the event that a determination shall have been made pursuant to Section 6(b) of this Agreement that Indemnitee is not entitled to indemnification, any judicial proceeding commenced pursuant to this Section 7 shall be conducted in all respects as a de novo trial on the merits, and Indemnitee shall not be prejudiced by reason of the adverse determination under Section 6(b).

*[Comment: Sections 7(b) through 7(e) seek to extend statutory indemnification rights pursuant to Section 145(f).]*

(c) If a determination shall have been made pursuant to Section 6(b) of this Agreement that Indemnitee is entitled to indemnification, the Company shall be bound by such determination in any judicial proceeding commenced pursuant to this Section 7, absent (i) a misstatement by Indemnitee of a material fact, or an omission of a material fact necessary to make Indemnitee's misstatement not materially misleading in connection with the application for indemnification, or (ii) a prohibition of such indemnification under applicable law.

(d) In the event that Indemnitee, pursuant to this Section 7, seeks a judicial adjudication of his rights under, or to recover damages for breach of, this Agreement, or to recover under any directors' and officers' liability insurance policies maintained by the Company, the Company shall pay on his behalf, in advance, any and all expenses (of the types



described in the definition of Expenses in Section 13 of this Agreement) actually and reasonably incurred by him in such judicial adjudication, regardless of whether Indemnitee ultimately is determined to be entitled to such indemnification, advancement of expenses or insurance recovery.

(e) The Company shall be precluded from asserting in any judicial proceeding commenced pursuant to this Section 7 that the procedures and presumptions of this Agreement are not valid, binding and enforceable and shall stipulate in any such court that the Company is bound by all the provisions of this Agreement. The Company shall indemnify Indemnitee against any and all Expenses and, if requested by Indemnitee, shall (within ten (10) days after receipt by the Company of a written request therefore) advance, to the extent not prohibited by law, such expenses to Indemnitee, which are incurred by Indemnitee in connection with any action brought by Indemnitee for indemnification or advance of Expenses from the Company under this Agreement or under any directors' and officers' liability insurance policies maintained by the Company, regardless of whether Indemnitee ultimately is determined to be entitled to such indemnification, advancement of Expenses or insurance recovery, as the case may be.

(f) Notwithstanding anything in this Agreement to the contrary, no determination as to entitlement to indemnification under this Agreement shall be required to be made prior to the final disposition of the Proceeding.

8. Non-Exclusivity; Survival of Rights; Insurance; Primacy of Indemnification; Subrogation.

(a) The rights of indemnification as provided by this Agreement shall not be deemed exclusive of any other rights to which Indemnitee may at any time be entitled under applicable law, the Certificate of Incorporation, the By-laws, any agreement, a vote of stockholders, a resolution of directors of the Company, or otherwise. No amendment, alteration or repeal of this Agreement or of any provision hereof shall limit or restrict any right of Indemnitee under this Agreement in respect of any action taken or omitted by such Indemnitee in his Corporate Status prior to such amendment, alteration or repeal. To the extent that a change in the DGCL, whether by statute or judicial decision, permits greater indemnification than would be afforded currently under the Certificate of Incorporation, By-laws and this Agreement, it is the intent of the parties hereto that Indemnitee shall enjoy by this Agreement the greater benefits so afforded by such change. No right or remedy herein conferred is intended to be exclusive of any other right or remedy, and every other right and remedy shall be cumulative and in addition to every other right and remedy given hereunder or now or hereafter existing at law or in equity or otherwise. The assertion or employment of any right or remedy hereunder, or otherwise, shall not prevent the concurrent assertion or employment of any other right or remedy.

(b) To the extent that the Company maintains an insurance policy or policies providing liability insurance for directors, officers, employees, or agents or fiduciaries of the Company or of any other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise that such person serves at the request of the Company, Indemnitee shall be covered by such policy or policies in accordance with its or their terms to the maximum extent of the coverage available for any director, officer, employee, agent or fiduciary under such policy or policies. If, at the time of the receipt of a notice of a claim pursuant to the terms hereof, the Company has directors' and officers' liability insurance in effect, the Company shall give prompt notice of the commencement of such proceeding to the insurers in accordance with the

procedures set forth in the respective policies. The Company shall thereafter take all necessary or desirable action to cause such insurers to pay, on behalf of the Indemnitee, all amounts payable as a result of such proceeding in accordance with the terms of such policies.

*[Comment: Some indemnification agreements require the corporation to obtain (or use commercially reasonable or best efforts to obtain) D&O insurance with specified policy limits or other terms. Instead, this agreement requires the corporation to furnish the Indemnitee with the maximum level of D&O insurance coverage provided to other like parties.]*

(c) [The Company hereby acknowledges that Indemnitee has certain rights to indemnification, advancement of expenses and/or insurance provided by [Name of Fund/Sponsor] and certain of [its][their] affiliates (collectively, the “Fund Indemnitors”). The Company hereby agrees (i) that it is the indemnitor of first resort (i.e., its obligations to Indemnitee are primary and any obligation of the Fund Indemnitors to advance expenses or to provide indemnification for the same expenses or liabilities incurred by Indemnitee are secondary), (ii) that it shall be required to advance the full amount of expenses incurred by Indemnitee and shall be liable for the full amount of all Expenses, judgments, penalties, fines and amounts paid in settlement to the extent legally permitted and as required by the terms of this Agreement and the Certificate of Incorporation or Bylaws of the Company (or any other agreement between the Company and Indemnitee), without regard to any rights Indemnitee may have against the Fund Indemnitors, and, (iii) that it irrevocably waives, relinquishes and releases the Fund Indemnitors from any and all claims against the Fund Indemnitors for contribution, subrogation or any other recovery of any kind in respect thereof. The Company further agrees that no advancement or payment by the Fund Indemnitors on behalf of Indemnitee with respect to any claim for which Indemnitee has sought indemnification from the Company shall affect the foregoing and the Fund Indemnitors shall have a right of contribution and/or be subrogated to the extent of such advancement or payment to all of the rights of recovery of Indemnitee against the Company. The Company and Indemnitee agree that the Fund Indemnitors are express third party beneficiaries of the terms of this Section 8(c).]

*[Comment: This provision is intended to be used for directors appointed by investment funds to address the ruling in Levy et al. v. HLI Operating Company, Inc., 2007 WL 1500032 (Del.Ch., May 16, 2007), which held that investment funds providing indemnification to their partners who serve on boards of fund portfolio companies are co-indemnitors with the portfolio company and, therefore, are not entitled to recover from the portfolio company the full amount of any payments advanced on behalf of the partner-director. Rather, the fund only has a claim for contribution to the extent it advanced more than its fair share. In the absence of a provision such as the above, it is possible the Levy case will be broadly construed to obligate a fund providing such indemnification to contribute its share of any payments made by any other party providing like indemnification to its director designees.]*

(d) Except as provided in paragraph (c) above, in the event of any payment under this Agreement, the Company shall be subrogated to the extent of such payment to all of the rights of recovery of Indemnitee (other than against the Fund Indemnitors), who shall execute all papers required and take all action necessary to secure such rights, including execution of such documents as are necessary to enable the Company to bring suit to enforce such rights.

(e) Except as provided in paragraph (c) above, the Company shall not be liable under this Agreement to make any payment of amounts otherwise indemnifiable hereunder if and to the extent that Indemnitee has otherwise actually received such payment under any insurance policy, contract, agreement or otherwise.

*[Comment: This provision integrates indemnification under the agreement with indemnification from other sources by providing that payments under the agreement shall be offset by payments from other sources, other than from the Fund Indemnitors as provided in paragraph (c).]*

(f) Except as provided in paragraph (c) above, the Company's obligation to indemnify or advance Expenses hereunder to Indemnitee who is or was serving at the request of the Company as a director, officer, employee or agent of any other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise shall be reduced by any amount Indemnitee has actually received as indemnification or advancement of expenses from such other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise.

9. Exception to Right of Indemnification. Notwithstanding any provision in this Agreement, the Company shall not be obligated under this Agreement to make any indemnity in connection with any claim made against Indemnitee:

(a) for which payment has actually been made to or on behalf of Indemnitee under any insurance policy or other indemnity provision, except with respect to any excess beyond the amount paid under any insurance policy or other indemnity provision, provided, that the foregoing shall not affect the rights of Indemnitee or the Fund Indemnitors set forth in Section 8(c) above; or

(b) for an accounting of profits made from the purchase and sale (or sale and purchase) by Indemnitee of securities of the Company within the meaning of Section 16(b) of the Securities Exchange Act of 1934, as amended, or similar provisions of state statutory law or common law; or

(c) in connection with any Proceeding (or any part of any Proceeding) initiated by Indemnitee, including any Proceeding (or any part of any Proceeding) initiated by Indemnitee against the Company or its directors, officers, employees or other indemnitees, unless (i) the Board authorized the Proceeding (or any part of any Proceeding) prior to its initiation or (ii) the Company provides the indemnification, in its sole discretion, pursuant to the powers vested in the Company under applicable law.

*[Comment: This provision is designed to prevent the indemnitee from being indemnified for actions brought by the indemnitee except as otherwise provided, as well as for liability under Section 16(b) of the 1934 Act and where payment has already been made under an insurance policy.]*

10. Duration of Agreement. All agreements and obligations of the Company contained herein shall continue during the period Indemnitee is an officer or director of the Company (or is or was serving at the request of the Company as a director, officer, employee or agent of another corporation, partnership, joint venture, trust or other enterprise) [consider extending for several years after term of service, even if claim has not yet been paid] and shall

continue thereafter so long as Indemnitee shall be subject to any Proceeding (or any proceeding commenced under Section 7 hereof) by reason of his Corporate Status, whether or not he is acting or serving in any such capacity at the time any liability or expense is incurred for which indemnification can be provided under this Agreement. [This Agreement shall be binding upon and inure to the benefit of and be enforceable by the parties hereto and their respective successors (including any direct or indirect successor by purchase, merger, consolidation or otherwise to all or substantially all of the business or assets of the Company), assigns, spouses, heirs, executors and personal and legal representatives.]

11. Security. To the extent requested by Indemnitee and approved by the Board, the Company may at any time and from time to time provide security to Indemnitee for the Company's obligations hereunder through an irrevocable bank line of credit, funded trust or other collateral. Any such security, once provided to Indemnitee, may not be revoked or released without the prior written consent of the Indemnitee.

12. Enforcement.

(a) The Company expressly confirms and agrees that it has entered into this Agreement and assumes the obligations imposed on it hereby in order to induce Indemnitee to serve as an officer or director of the Company, and the Company acknowledges that Indemnitee is relying upon this Agreement in serving as an officer or director of the Company.

(b) This Agreement constitutes the entire agreement between the parties hereto with respect to the subject matter hereof and supersedes all prior agreements and understandings, oral, written and implied, between the parties hereto with respect to the subject matter hereof.

(c) The Company shall not seek from a court, or agree to, a "bar order" which would have the effect of prohibiting or limiting the Indemnitee's rights to receive advancement of expenses under this Agreement.

*[Comment: See In re HealthSouth Corp. Securities Litigation, 572 F.3d 854 (11th Cir. 2009).]*

13. Definitions. For purposes of this Agreement:

(a) "**Corporate Status**" describes the status of a person who is or was a director, officer, employee, agent or fiduciary of the Company or of any other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise that such person is or was serving at the express written request of the Company.

(b) "**Disinterested Director**" means a director of the Company who is not and was not a party to the Proceeding in respect of which indemnification is sought by Indemnitee.

(c) "**Enterprise**" shall mean the Company and any other corporation, partnership, joint venture, trust, employee benefit plan or other enterprise that Indemnitee is or was serving at the express written request of the Company as a director, officer, employee, agent or fiduciary.

(d) “**Expenses**” shall include all reasonable attorneys’ fees, retainers, court costs, transcript costs, fees of experts, witness fees, travel expenses, duplicating costs, printing and binding costs, telephone charges, postage, delivery service fees and all other disbursements or expenses of the types customarily incurred in connection with prosecuting, defending, preparing to prosecute or defend, investigating, participating, or being or preparing to be a witness in a Proceeding, or responding to, or objecting to, a request to provide discovery in any Proceeding. Expenses also shall include Expenses incurred in connection with any appeal resulting from any Proceeding [and any federal, state, local or foreign taxes imposed on the Indemnitee as a result of the actual or deemed receipt of any payments under this Agreement], including without limitation the premium, security for, and other costs relating to any cost bond, supersede as bond, or other appeal bond or its equivalent. Expenses, however, shall not include amounts paid in settlement by Indemnitee or the amount of judgments or fines against Indemnitee.

(e) “**Independent Counsel**” means a law firm, or a member of a law firm, that is experienced in matters of corporation law and neither presently is, nor in the past five years has been, retained to represent: (i) the Company or Indemnitee in any matter material to either such party (other than with respect to matters concerning Indemnitee under this Agreement, or of other indemnitees under similar indemnification agreements), or (ii) any other party to the Proceeding giving rise to a claim for indemnification hereunder. Notwithstanding the foregoing, the term “Independent Counsel” shall not include any person who, under the applicable standards of professional conduct then prevailing, would have a conflict of interest in representing either the Company or Indemnitee in an action to determine Indemnitee’s rights under this Agreement. The Company agrees to pay the reasonable fees of the Independent Counsel referred to above and to fully indemnify such counsel against any and all Expenses, claims, liabilities and damages arising out of or relating to this Agreement or its engagement pursuant hereto.

(f) “**Proceeding**” includes any threatened, pending or completed action, suit, arbitration, alternate dispute resolution mechanism, investigation, inquiry, administrative hearing or any other actual, threatened or completed proceeding, whether brought by or in the right of the Company or otherwise and whether civil, criminal, administrative or investigative, in which Indemnitee was, is or will be involved as a party or otherwise, by reason of his or her Corporate Status, by reason of any action taken by him or of any inaction on his part while acting in his or her Corporate Status; in each case whether or not he is acting or serving in any such capacity at the time any liability or expense is incurred for which indemnification can be provided under this Agreement; including one pending on or before the date of this Agreement, but excluding one initiated by an Indemnitee pursuant to Section 7 of this Agreement to enforce his rights under this Agreement.

14. Severability. The invalidity or unenforceability of any provision hereof shall in no way affect the validity or enforceability of any other provision. [Further, the invalidity or unenforceability of any provision hereof as to either Indemnitee or Appointing Stockholder shall in no way affect the validity or enforceability of any provision hereof as to the other.] Without limiting the generality of the foregoing, this Agreement is intended to confer upon Indemnitee [and Appointing Stockholder] indemnification rights to the fullest extent permitted by applicable laws. In the event any provision hereof conflicts with any applicable law, such provision shall be deemed modified, consistent with the aforementioned intent, to the extent necessary to resolve such conflict.

*[Comment: Use the bracketed language in Section 14 if a version of the indemnification of Appointing Stockholder language is used in Section 1(d)]*

15. Modification and Waiver. No supplement, modification, termination or amendment of this Agreement shall be binding unless executed in writing by both of the parties hereto. No waiver of any of the provisions of this Agreement shall be deemed or shall constitute a waiver of any other provisions hereof (whether or not similar) nor shall such waiver constitute a continuing waiver.

16. Notice By Indemnitee. Indemnitee agrees promptly to notify the Company in writing upon being served with or otherwise receiving any summons, citation, subpoena, complaint, indictment, information or other document relating to any Proceeding or matter which may be subject to indemnification covered hereunder. The failure to so notify the Company shall not relieve the Company of any obligation which it may have to Indemnitee under this Agreement or otherwise unless and only to the extent that such failure or delay materially prejudices the Company.

17. Notices. All notices and other communications given or made pursuant to this Agreement shall be in writing and shall be deemed effectively given: (a) upon personal delivery to the party to be notified, (b) when sent by confirmed electronic mail or facsimile if sent during normal business hours of the recipient, and if not so confirmed, then on the next business day, (c) five (5) days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (d) one (1) day after deposit with a nationally recognized overnight courier, specifying next day delivery, with written verification of receipt. All communications shall be sent:

- (a) To Indemnitee at the address set forth below Indemnitee signature hereto.
- (b) To the Company at:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
Attention: \_\_\_\_\_

or to such other address as may have been furnished to Indemnitee by the Company or to the Company by Indemnitee, as the case may be.

18. Counterparts. This Agreement may be executed in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same Agreement. This Agreement may also be executed and delivered by facsimile signature and in two or more counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

19. Headings. The headings of the paragraphs of this Agreement are inserted for convenience only and shall not be deemed to constitute part of this Agreement or to affect the construction thereof.

20. Governing Law and Consent to Jurisdiction. This Agreement and the legal relations among the parties shall be governed by, and construed and enforced in accordance with,

the laws of the State of Delaware, without regard to its conflict of laws rules. The Company and Indemnitee hereby irrevocably and unconditionally (i) agree that any action or proceeding arising out of or in connection with this Agreement shall be brought only in the Chancery Court of the State of Delaware (the “**Delaware Court**”), and not in any other state or federal court in the United States of America or any court in any other country, (ii) consent to submit to the exclusive jurisdiction of the Delaware Court for purposes of any action or proceeding arising out of or in connection with this Agreement, [(iii) appoint, to the extent such party is not otherwise subject to service of process in the State of Delaware, irrevocably [name] [address] as its agent in the State of Delaware as such party's agent for acceptance of legal process in connection with any such action or proceeding against such party with the same legal force and validity as if served upon such party personally within the State of Delaware,] [*NOTE: as the Delaware-incorporated Company is already subject to service of process in Delaware, this really only applies to the individual director.*] (iv) waive any objection to the laying of venue of any such action or proceeding in the Delaware Court, and (v) waive, and agree not to plead or to make, any claim that any such action or proceeding brought in the Delaware Court has been brought in an improper or inconvenient forum.

***SIGNATURE PAGE TO FOLLOW***

IN WITNESS WHEREOF, the parties hereto have executed this Indemnification Agreement on and as of the day and year first above written.

**COMPANY**

By: \_\_\_\_\_  
Name: \_\_\_\_\_  
Title: \_\_\_\_\_

**INDEMNITEE**

\_\_\_\_\_  
Name: \_\_\_\_\_

Address: \_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_



**This sample document is the product of a Working Group of lawyers who specialize in venture capital financings, acting under the auspices of the NVCA. See the NVCA website for a list of Working Group members. This document is intended to serve as a starting point only, and should be tailored to meet the specific requirements of the State in which you practice, as well as the opinion practices and procedures of your law firm. This document should not be construed as legal advice, nor should the participation of lawyers in the Working Group be construed as an indication of their willingness to give or advise the acceptance of this form of opinion.**

## **FORM OF LEGAL OPINION**

*Below is an example of the legal opinions that might be given in a typical venture-backed preferred stock financing. As most law firms have their own forms and the opinions given depend on the specific circumstances, this is meant only as a starting point for reference purposes.*

*NOTE: The following assumes a Delaware corporation headquartered in California.*

Based upon the foregoing and subject to the additional qualifications set forth below, we are of the opinion that:

1. The Company is validly existing as a corporation<sup>1</sup> and in good standing under Delaware law and is qualified as a foreign corporation and in good standing in [California].
2. The Company has the corporate power to execute and deliver the Transaction Documents<sup>2</sup> in which it is named as a party and to perform its obligations thereunder.<sup>3</sup>
3. The Company has duly authorized, executed and delivered the Transaction Documents in which it is named as a party, and such Transaction Documents constitute its valid and binding obligations<sup>4</sup> enforceable against it in accordance with their terms.<sup>5</sup>

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<sup>1</sup> Opinion recipients sometimes request an opinion that the Company is “duly incorporated.” This opinion requires the opinion preparers to conduct a more extensive inquiry into the past than an opinion that the “Company is validly existing as a corporation” and, at least in the venture financing context, often is not cost justified. See *Third-Party “Closing” Opinions: A Report of The TriBar Opinion Committee*, 53 Bus. Law 591, 651–652 (1998). Ordinarily, an opinion that a Company has been “duly organized” should be avoided because of uncertainty as to what additional matters, if any, it covers.

<sup>2</sup> Opinion preparers should take care that the Company’s certificate of incorporation is not included in the definition of “Transaction Documents.” Inclusion of the certificate of incorporation would be both illogical (e.g., in the case of the due execution and delivery opinion) and troublesome (e.g., in the case of the enforceability opinion).

<sup>3</sup> Opinion recipients sometimes ask that this opinion be broadened, for example to cover the Company’s corporate power to conduct its business. If given, this broader opinion typically is based on a description in a disclosure document or an officer’s certificate.

<sup>4</sup> Note that this opinion covers only obligations of the Company and, therefore, does not cover obligations of other parties to the Transaction Documents, such as investors and other stockholders. Sometimes, an opinion recipient requests that the enforceability opinion be expanded to cover those parties to give the recipient comfort that important obligations, such as promises by those parties to vote stock in favor of the election of directors designated by the recipient, also are enforceable. Since the law of many states permits the enforcement of promises to vote stock, in appropriate circumstances, counsel to the Company might be able to give that opinion based on an assumption as to status and due authorization, execution and delivery in the case of parties that are entities, and legal capacity, due execution and delivery in the case of parties who are natural persons. Such an opinion, however, may be of limited value to an opinion recipient whose principal concern is the availability of specific performance as a remedy, since equitable remedies are excluded from the opinion’s coverage by the equitable principles limitation.

<sup>5</sup> Often, the law covered by the opinion letter is the same as the law chosen as the governing law in the Transaction Documents. When that is not the case, apart from obtaining an opinion of counsel in the state whose law is chosen as the governing law, several alternatives are available. These include giving an opinion on whether the law chosen  
(continued...)

4. The execution and delivery by the Company of the Transaction Documents and the performance by the Company of its obligations under the Transaction Documents, including its issuance and sale of the Preferred Shares and issuance of shares of Common Stock upon conversion of the Preferred Shares in accordance with the Company's certificate of incorporation (the "Conversion Shares"), do not and will not (i) violate the Delaware General Corporation Law ("DGCL"), the law of [indicate state whose law is generally covered by the opinion letter] or United States federal law,<sup>6</sup> (ii) violate any court order, judgment or decree, if any, listed in [Schedule \_\_ to this opinion letter] [Schedule \_\_ to the Purchase Agreement], (iii) result in a breach of, or constitute a default under, any of the agreements or instruments listed in Schedule \_\_ to this opinion letter<sup>7</sup>, or (iv) violate the Company's certificate of incorporation or by-laws.

5. The Company is not required to obtain any consent, approval, license or exemption by, or order or authorization of, or to make any filing, recording or registration with, any governmental authority pursuant to the DGCL, the law of [indicate state whose law is generally covered by the opinion letter] or United States federal law in connection with the execution and delivery by the Company of the Transaction Documents in which it is named as a party or the performance by it of its obligations other than those that have been obtained or made.<sup>8</sup>

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(continued...)

as the governing law will be given effect under the law covered by the opinion or, alone or in combination with the choice-of-law opinion, giving an opinion on the enforceability of the Transaction Documents as though the law covered by the opinion governed the Transaction Documents. If the Company is incorporated in Delaware rather than the state whose law is generally covered by the opinion letter, the opinion letter typically will state that it also covers the Delaware General Corporation Law ("DGCL"). Unless otherwise expressly stated, the enforceability opinion will cover the DGCL to the extent the internal affairs doctrine of the state whose law is generally covered by the enforceability opinion deems the DGCL applicable to the agreement. Among the provisions of the agreement to which the DGCL is likely to be deemed applicable are provisions relating to the governance of the Company.

<sup>6</sup> For the law covered, see part II of the ABA Legal Opinion Principles, 53 Bus. Law. 831 (1998). Opinion recipients and preparers should agree on whether this opinion should be drafted to cover industry-specific laws that are applicable to the business of the Company and could have applicability to the transaction but are not generally reviewed in connection with the types of transactions covered by the Transaction Documents, such as laws applicable to companies in the financial services industry.

<sup>7</sup> Consideration should be given to which contracts should be covered in light of the cost constraints of many venture financings.

<sup>8</sup> Securities law approvals and filings are understood as a matter of customary practice not to be covered by this opinion unless referred to specifically. Some lawyers, however, choose to make this explicit by including an exception (such as: ", except [the filing of a Form D pursuant to Regulation D of the Securities Act] and the notice filing required by [Section 25102(f) or 25102.1 of the California Corporate Securities Law of 1968, as amended]") or a statement indicating that the only opinion covering securities laws is in numbered paragraph 8. Such an exclusion does not mean that other laws customarily understood to be excluded are covered.

6. The authorized capital stock of the Company consists of (i) \_\_\_\_\_ shares of Common Stock, \$0.01 par value, of which \_\_\_\_\_ shares are issued and outstanding, and (ii) \_\_\_\_\_ shares of Preferred Stock, \$0.01 par value, of which \_\_\_\_\_ shares have been designated Series A Preferred Stock, \_\_\_\_\_ shares of which are issued and outstanding, and \_\_\_\_\_ shares have been designated Series B Preferred Stock, none of which are issued and outstanding.<sup>9</sup> All such issued and outstanding shares have been duly authorized and validly issued and are fully paid and nonassessable.<sup>10</sup>

7. The Preferred Shares have been duly authorized, and when issued, delivered and paid for in accordance with the Purchase Agreement, will be validly issued, fully paid and nonassessable.<sup>11</sup> The Conversion Shares have been duly authorized and, when issued in accordance with the Company's certificate of incorporation upon conversion of the Preferred Shares, will be validly issued, fully paid and nonassessable.<sup>12</sup> Neither the issuance or sale of the

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<sup>9</sup> Because of its factual nature, some law firms are unwilling to give an opinion on the number of outstanding shares. To avoid any misunderstanding that an opinion on the number of outstanding shares is in essence anything more than a factual confirmation, law firms that are willing to give that opinion often do so only if they also are giving an opinion on the valid issuance of the Company's outstanding shares (see note 10).

<sup>10</sup> Because the opinion on the valid issuance of the outstanding shares will require a review of each issuance of shares, in many situations it will not be cost justified. For a description of the work customarily required to be performed to give this opinion, see *Special Report of the TriBar Opinion Committee: Duly Authorized Opinions on Preferred Stock*, 63 Bus. Law. 921 (2008).

Opinion recipients sometimes ask an opinion giver to state that, to the opinion giver's knowledge, the Company has no outstanding options, warrants or other rights to acquire Company stock other than as disclosed in the Transaction Documents. Many law firms are unwilling to give this opinion because it constitutes negative assurance on a factual matter they rarely are in a position to confirm. When, however, the opinion is given, the opinion letter should describe what the opinion preparers have done to support it.

<sup>11</sup> Although understood as a matter of customary practice to be covered by the "duly authorized" opinion, some opinion recipients ask opinion givers to state expressly that the rights, powers, and preferences of the Preferred Shares set forth in the certificate of incorporation do not violate the DGCL or the Company's certificate of incorporation. Note that the "duly authorized" opinion, whether or not it includes that additional statement, is not an opinion on the enforceability of the terms of the Preferred Shares. See "Special Report of the TriBar Opinion Committee: Duly Authorized Opinions on Preferred Stock," 63 Bus. Law. 921 (2008).

<sup>12</sup> Because shares may be issued in the future under antidilution clauses or otherwise, as a matter of customary practice this opinion is understood to mean that sufficient authorized shares are available on the date of the opinion letter, not that sufficient authorized shares necessarily will be available on the conversion date. To make the limited nature of the opinion clear, some opinion preparers include an express assumption regarding the availability of sufficient authorized shares in the future..

Opinion recipients sometimes ask for an opinion that a specified number of shares (at least sufficient to cover issuance of the Conversion Shares) has been reserved for issuance. Many firms will not give this opinion because the concept of reservation, at least in Delaware and California, has no statutory meaning and the issue of the number of shares the Company has committed to issue is essentially factual (see note 9). Some firms will, however, give what is often an acceptable alternative, namely, an opinion that the board of directors has duly adopted a resolution reserving a specified number of shares for issuance on conversion of the Preferred Shares and that the resolution remains in full force and effect.

Preferred Shares nor the issuance of the Conversion Shares is subject to any preemptive rights under the DGCL or the Company's certificate of incorporation or by-laws.<sup>13</sup>

8. Based on, and assuming the accuracy of, the representations of each of the Purchasers in the Purchase Agreement, the sale of the Preferred Shares pursuant to the Purchase Agreement does not, and the issuance of the Conversion Shares upon conversion of the Preferred Shares in accordance with the Company's certificate of incorporation will not (assuming no commission or other remuneration is paid or given directly or indirectly for soliciting the conversion),<sup>14</sup> require registration under the Securities Act.<sup>15/16</sup>

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<sup>13</sup> Even though a valid issuance opinion could not be given on shares issued in violation of preemptive rights granted by statute or the Company's certificate of incorporation or by-laws, opinion recipients sometimes request an opinion that expressly addresses the absence of those rights. Such an opinion does not cover contractual rights (which may be covered by the no breach or default opinion in numbered opinion 4(iii) above).

<sup>14</sup> Ordinarily, no registration opinions covering the future issuance of the Conversion Shares are based on an assumption that the conditions for availability of the exemption provided by Section 3(a)(9) from the registration requirements of the Securities Act of 1933 will be satisfied at the time of conversion. In the factual situation covered by this form, the only condition that needs to be assumed is that no commission or other remuneration will have been paid when the shares are converted. As in this form, some opinion givers state this assumption expressly. Other opinion givers do not for various reasons, including their belief that satisfaction of the matters assumed is so well understood that it does not have to be stated. No registration opinions are discussed in Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, *No Registration Opinions*, 63 Bus. Law. 187 (2007).

<sup>15</sup> As provided in this form, the no registration opinion is usually given in reliance on appropriate representations and warranties set forth in the Purchase Agreement (or information obtained in other ways, such as back-up certificates from the Company) relating to the absence of "general solicitation" and "general advertising" and prior sales of similar securities that could be integrated with the offering covered by the opinion. (If a placement agent is involved, the opinion also is usually based on representations and warranties of, or a certificate from, the placement agent.) Some opinion givers expressly exclude coverage of the no "general solicitation" and "general advertising" requirement from the opinion (that requirement is contained in Rule 502(c) of Regulation D and is understood to be a condition of compliance with the exemption provided by Section 4(2) of the Securities Act). See Subcommittee on Securities Law Opinions, Committee on Federal Regulation of Securities, ABA Section of Business Law, *No Registration Opinions*, 63 Bus. Law. 187 (2007).

<sup>16</sup> When warrants, options or other rights to acquire Company stock are exercisable upon the payment of cash, the no registration opinion can raise difficult issues because the exemption under Section 3(a)(9) of the Securities Act would not be available (other than possibly if the warrants, options or other rights are exercised on a net exercise basis) and the availability of another exemption, such as under Section 4(2) of the Securities Act, would depend on the facts at the time of exercise. Accordingly, many firms will not give a no registration opinion on the issuance of shares upon the future exercise of warrants, options or other rights. Some firms, however, will give the opinion based on an express assumption that the warrants, options or other rights were exercised and the underlying shares issued at the closing of the sale of the Preferred Shares.

Except as disclosed in Schedule \_\_ to the Purchase Agreement, we are not representing the Company in any pending litigation in which it is a named defendant that challenges the validity or enforceability of, or seeks to enjoin the performance of, the Transaction Documents.<sup>17</sup>

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<sup>17</sup> This version of the "no-litigation" confirmation is narrower than the version that historically has been given, which covered litigation against the company generally. Because of its factual nature and in light of recent cases brought against law firms by recipients of no-litigation confirmations, many law firms no longer are willing to give the broader no-litigation confirmation, and some firms are unwilling to give any confirmation relating to litigation.

Although this form obviates the need for the phrase "to our knowledge" or a variant of it, other forms include that phrase. When they do, a definition of "knowledge" normally should be included to avoid misunderstanding as to the meaning of the term. An example of a definition that is derived from the ABA Legal Opinion Principles (see note 5) (and that would apply if no definition were included) is:

When the phrase "to our knowledge" or an equivalent phrase is used in this opinion, its purpose is to limit the statements it qualifies to the actual knowledge of the lawyers in this firm responsible for preparing this opinion letter after such inquiry as they deemed appropriate.

Some opinions preparers include in the definition in place of "this opinion letter" the phrase "the particular opinion or confirmation containing that reference." Also, some opinion preparers refer to "conscious awareness" instead of "actual knowledge."

In preparing the confirmation, the opinion preparers normally would conduct an inquiry of those lawyers in their firm who the opinion preparers believe are reasonably likely to have information not otherwise known to them that is called for by the confirmation. As a matter of customary practice, the confirmation is understood not to cover information known to other lawyers in the firm but not known to the opinion preparers after such inquiry. Depending on the circumstances and the wording of the confirmation, the opinion preparers also might make inquiry of appropriate officials of the Company. In preparing a no litigation confirmation, the opinion preparers are not required as a matter of customary diligence to check court or other public records. Although not necessary, some opinion preparers choose to make this clear, for example, by stating expressly that they did not examine court or other public records.

If the opinion preparers are aware that, unknown to the opinion recipient, a material legal proceeding is being handled by another firm, they should consider whether providing a confirmation (however worded) regarding litigation without noting the existence of that legal proceeding would be misleading to the opinion recipient.