Summary of General Term Sheet Definitions

The following is a brief summary of terms and concepts commonly used in Angel and Venture Capital transactions.

- **Anti-Dilution Protection.** The conversion price of the preferred stock will be subject to adjustment for diluting events, such as stock splits or stock dividends, and will probably also be subject to "price protection," which is adjustment upon future sales of stock at prices below the conversion price. Price protection can take many forms, from an extreme "full-ratchet" protection which lowers the conversion price to the price at which any new stock is sold, no matter the number of shares, to a broad-based "weighted average" protection which adjusts the conversion price based on a formula incorporating both the number of new shares being issued and their price. The issuance of a certain number of shares is generally excluded from this protection to cover anticipated issuances to key employees, consultants and directors. Price protection is sometimes subject to a "pay-to-play" provision, which makes the continuation of such protection for a given investor contingent on that investor purchasing at least its pro-rata share of any future issuances priced below the conversion price.

- **Bridge Financing.** A loan is used to provide the company with operating capital while the investors conduct due diligence and negotiate the terms of the investment. The bridge loan is usually converted into equity at the next equity financing of the company.

- **Broad-Based Weighted Average Antidilution.** A type of anti-dilution mechanism. Weighted average anti-dilution protection adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to a weighted average of investor A's price and investor B's price. Broad-based weighted average anti-dilution protection uses all common stock outstanding on a fully diluted basis (including all convertible securities, warrants and options) in the denominator of the formula for determining the new weighted average price.

- **Come Along Rights.** Sometimes also called Tag Along Rights. The right of an investor to sell shares, if a founder or other key employee sells shares. This right is designed to protect the investors against being trapped in an investment after the founders have cashed out.

- **Co-Sale Right.** Preferred investors often will require founders to enter into a co-sale agreement. A co-sale right provides some protection against founders selling their interest in the company to a third party by giving investors the right to sell a portion of their stock as part of any such sale.

- **Conversion Rights.** Preferred stock will be convertible into common stock at some conversion ratio, which is typically expressed as the initial purchase price of the preferred stock divided by a "conversion price" which initially equals the purchase price but is subject to adjustment upon the happening of certain events. Conversion is generally available at any time at the option of the stockholder and may be automatically triggered by certain occurrences, such as an initial public offering.

- **Convertible.** The right of the investor to convert shares of Preferred Stock into shares of Common Stock at the Conversion Rate stated in the corporate charter. Conversion is usually automatic upon the occurrence of a Qualified IPO. Mandatory conversion is necessary because companies sell Common Stock in their IPOs and new investors are not likely to purchase Common Stock, if earlier investors retain Preferred Stock with superior rights

- **Covenant.** The obligation in a contact to do something. An obligation to refrain from doing something is called a Negative Covenant. For example, the obligation to obtain life insurance on key employees is a covenant and the obligation to not deviate from the budget approved by investors is a negative covenant.

- **Cumulative Dividend.** If the dividend is not declared during the period stated in the corporate charter, the dividend accrues and is payable in a later period. If a dividend right isn't cumulative, the dividend would be lost forever if it's not declared during the period stated in the corporate charter. Accrued but unpaid dividends are sometimes convertible into shares of Common Stock.

- **Cutback Rights.** Where shareholders exercise piggyback registration rights, but there are too many shares for the underwriters to sell in the public offering without adversely affecting the price, cutback rights determine whose shares are left out of the offering and whose shares are included in the offering.

- **Demand Registration Rights.** The right of investors to require the company to register the investors' shares for sale to the public even if the company was not otherwise planning to conduct a public offering. Usually, an investor or group of investors receives one or two Demand Registration Rights. Typically, the right isn't exercisable until after the company's initial public offering or after a stated time period.

- **Dividend Preference.** Generally, a dividend must be paid to the preferred stock before any dividend is paid to the common stock. This dividend may be non-cumulative and discretionary, or it may be cumulative so that it accrues from year to year until paid in full.

- **Drag-Along Rights**. The right of majority stockholders, obligating stockholders whose shares are bound into the stockholders' agreement to sell their shares into an offer the majority wishes to execute.

- **First Refusal Rights.** The right to purchase stock in future offerings by the company on the same terms as other investors. Usually the right is designed to enable investors to maintain their percentage ownership of the company by purchasing a pro rata share of all new stock sold by the company. Investors also often require company founders to grant first refusal rights on shares the founders own. Also sometimes called Preemptive Rights.

- **Full Ratchet Antidilution**. The sale of a single share at a price less than the favored investors' purchase price reduces the conversion price of the favored investors' convertible preferred stock "to the penny". For example, from $1.00 to 50 cents, regardless of the number of lower priced shares sold.

- **Fully Diluted Outstanding Shares**. The number of shares representing total company ownership, including common shares and current conversion or exercised value of the preferred shares, options, warrants, and other convertible securities. This number usually includes not only issued options, but also shares available for issuance under the company's equity incentive plan.

- **Information Rights.** The rights of investors to have the company provide financial information annually, quarterly or monthly and other information as requested by investors.

- **Key Man Insurance.** Insurance on the life of key employees which investors require the company to obtain.

- **Lead Investor.** The investor who takes on most of the work in negotiating the investment terms, doing due diligence and monitoring the company after the closing. The lead investor usually invests more than other investors who participate in the round. The lead investor is often located near the company or specializes in the company's industry.

- **Liquidation Preference.** Upon liquidation of the company, the preferred stock will receive a certain fixed amount before any assets are distributed to the common stock. "Participating preferred" stock will not only receive this fixed amount, but then also will participate in some manner with the common stock in further distributions. However, such participation is sometimes limited to a certain multiple of the issue price of the preferred stock.

- **Liquidity Event**. An event that allows an investor to realize a gain or loss on an investment. The ending of an investor's involvement in a business venture with a view to realizing an internal return on investment. Most common exit routes include initial public offerings, buybacks and secondary buyouts.

- **Lock-up Period.** The period of time that certain stockholders have agreed to waive their right to sell their shares of a public company. Investment banks that underwrite initial public offerings generally insist upon lockups of at least 180 days from large stockholders (1% ownership or more) in order to allow an orderly market to develop in the shares. The stockholders that are subject to lockup usually include the management and directors of the company, strategic partners and large investors. These stockholders have typically invested prior to the IPO at a significantly lower price to that offered to the public and therefore stand to gain considerable profits. If a stockholder attempts to sell shares that are subject to lockup during the lockup period, the transfer agent will not permit the sale to be completed.

- **Narrow-Based Weighted Average Anti-Dilution Protection**. A type of anti-dilution mechanism. Weighted average anti-dilution protection adjusts downward the price per share of the preferred stock of investor A due to the issuance of new preferred shares to new investor B at a price lower than the price investor A originally received. Investor A's preferred stock is repriced to a weighted average of investor A's price and investor B's price. Narrow-based weighted average anti-dilution protection uses only stock outstanding in the denominator of the formula for determining the new weighted average price.

- **Option Pool.** A number of shares of Common Stock specified in the corporate charter that can be sold to employees, officers and directors at low prices without triggering the Price Anti-dilution Protection of the Preferred Stock. 15% of the fully diluted shares are fairly typical, although the size of the Option Pool usually depends on the number of shares estimated to be necessary to grant to employees to attract a team capable of achieving the goals of the company's business plan. This varies from one company to another. Option Pool shares is usually considered to be outstanding shares when calculating the company's valuation.

- **Overallotment Option.** The right of investors to exercise the First Refusal Rights and Come Along Rights of other investors who don't exercise their own rights.

- **Participating Preferred Stock.** A class of stock with a Liquidation Preference, whereby on liquidation, sale or merger of the company, the owner has the right to share on an equal basis with holders of Common Stock any money or other assets that remain for distribution after payment of the Liquidation Preference of the Preferred Stock. With Nonparticipating Preferred Stock, the holders of Preferred Stock must choose either to receive their Liquidation Preference or to receive the same distribution holders of Common Stock receive. A holder of Participating Preferred Stock doesn't have to choose and receives both.

- **Piggyback Registration Rights.** The right of investors to have share included in a public offering the company plans to conduct for itself or another shareholder. Usually, this applies to an unlimited number of offerings until the registration rights terminate.

- **Post-Money Valuation.** Calculated by adding the dollar amount invested in the transaction to the Pre-Money Valuation.

- **Preemptive Right.** A stockholder's right to acquire an amount of shares in a future offering at the price per share paid by new investors, whereby his/her percentage ownership remains the same as before the offering if he/she exercises the right.

- **Preferred Stock.** A class of stock with a Liquidation Preference; that is, the right to receive distributions of money or assets prior to one or more other classes of stock if the company is sold, merged or liquidated. This protects investors by ensuring the investors get their money back (and sometimes a fixed return on the investment) before holders of Common Stock receive any money or assets.

- **Pre-Money Valuation.** The theoretical value of the company before the investment agreed upon by the company and the investors. Pre-Money Valuation is calculated by multiplying the number of Fully Diluted shares of the company before the investment transaction by the purchase price per share in the investment transaction.

- **Price Anti-dilution Protection.** Protects investors from overpaying for stock by adjusting the Conversion Ratio if the company later issues shares for a price less than the price the investors paid. Adjustment of the Conversion Ratio results in more shares of Common Stock becoming issuable upon conversion of each share of Preferred Stock than was agreed at the time of the investment. There are two basic types of Price Anti-dilution Protection; Full Ratchet and Weighted Average. Weighted Average can be either Broad Based or Narrow Based.

- **Price/Valuation.** Investors use a number of different methods to determine a company's valuation and the price they will pay for their investment, from a discounted cash flow approach based on business plan projections, to a more arbitrary figure based on a desire to own a predetermined percentage of the company in return for the anticipated level of funding needed to achieve a certain milestone.

- **Protective Provisions.** The right of an investor or group of investors to veto certain transactions by the company. This is usually achieved by prohibiting certain transactions, unless they are approved by a class vote of the Preferred Stock.

- **Play or Pay.** A provision that penalizes investors who fail to purchase there pro rata share of securities in a later investment round.

- **Qualified IPO.** Means an initial public offering by the company of a size and price specified in the corporate charter. An IPO with $20 million in gross proceeds to the company and a price per share three times the price the investor paid for its stock is fairly typical for a Qualified IPO, but this varies from one deal to another

- **Redemption**. Preferred stock may be redeemable, either at the option of the Company or the investors or mandatorily on a certain date, perhaps at some premium over the initial purchase price of the stock.

- **Registration Rights.** Preferred investors generally will receive registration rights as a part of their investment. These rights provide liquidity to investors by allowing them to require the company to register their shares for sale to the public either as part of an offering already contemplated by the Company ("piggyback rights") or in a separate offering initiated at the investors' request ("demand rights").

- **S-3 Registration Rights.** The right of investors to require the company to file a short form registration statement on Form S-3. S-3 Registration Rights are similar to Demand Registration Rights, but usually one or two registrations each year are permitted, because the short Form S-3 is less burdensome to the company.

- **Syndicate.** The groups of venture investors who participate in the investment round.

- **Type of Security.** Companies typically sell convertible preferred stock to investors which provide a preference payment to the preferred stock in the event the company is acquired or otherwise liquidated and also other preferences over the common stock held by the company's founders. These preferences help justify a much higher price for the preferred stock than the price paid by founders for the common stock.

- **Vesting on Founders Stock.** As a protection against founders leaving the company after the investment money is in, venture capitalists generally insist on some sort of "vesting" on founder's stock, so that a percentage of such stock, decreasing over time, is subject to repurchase by the company at cost if a founder terminates his or her employment. Often such vesting is accelerated on certain events such as a change of control of the company, a termination of the founder's employment by the company without cause or a termination of the founder's employment by the founder for good reason.

- **Visitation Rights.** Also called Observer Rights. The right of investors to have a nonvoting representative attends meetings of the Board of Directors of the company and committees of the Board.

- **Voting Rights**. On general matters, preferred stock usually votes along with common stock and has a number of votes equal to the number of shares of common stock into which it is convertible. The preferred stock also typically has special voting rights, such as the right to elect one or more of the company's directors or to approval certain types of corporate actions, such as amendments of the articles of incorporation, mergers or creation of a new series of preferred stock.

- **Warrant.** The right to purchase stock at a later date at a fixed price. Similar to stock options, but usually given to investors, not employees.

- **Warrant Coverage.** Warrants issued to reward bridge loan lenders, guarantors or other lenders for incurring the risk of lending. The number of shares issuable upon exercise of the warrants is based on a percentage of the debt.

- **Weighted Average.** A form of Anti-dilution Protection that adjusts the Conversion Ratio according to a formula that takes into account both the lower price and the number of shares issued at the lower price. This is more favorable to the company than a Full Ratchet. Narrow Based Weighted Average uses only the number of outstanding shares of Preferred Stock in the formula used to adjust the conversion price. This is more favorable to the investor than Broad Based Weighted Average, which includes all fully diluted shares in its formula.