



## Model Term Sheet for Alliance of Angels

This model term sheet, by Dan Rosen, CEO Dan Rosen & Associates, is for use by Alliance of Angels members as a starting point in negotiating seed stage deals. The AoA lead investor is noted as <<AoA Investors>> in the document. Each party in such deals should seek appropriate legal counsel. Except for the sections titled "Exclusivity" and "Confidentiality," this term sheet does not create a legally binding obligation on any person or entity.

<b>Company name</b>	Acme, Inc
<b>Location</b>	<<Company Address>>
<b>Type of Entity</b>	Washington State C Corporation
<b>Type of Equity</b>	Series A Preferred Stock
<b>Size of Offering</b>	\$750,000
<b>Minimum to close</b>	\$500,000
<b>Closing</b>	On <<Date>> ("the Closing Date") or when minimum to close is committed
<b>Valuation</b>	
<b>Pre-money</b>	\$2,000,000
<b>Post-money</b>	\$2,750,000
<b>Price per share</b>	\$1.0256

**Comment [DR1]:** Some prefer Delaware incorporation. Washington state and Delaware have parallel laws, but Delaware has greater case law and therefore better protection for company Directors.

**Comment [DR2]:** At times, Angels are asked to buy either common stock or S-Corp stock. Common makes sense in a limited situation: where an experienced entrepreneur has put lots of their own money into a company and you trust (based on experience with that individual) that they will treat investors well. S Corps cannot give preferred shares and should be avoided.

**Comment [DR3]:** Might also want to specify a latest close date for the round. If not met, it forces the company to come back to investors.

**Investors** Various members of the Alliance of Angels, who are Accredited Investors acting on their own account, and/or other Accredited Investors only (as defined in SEC Rule 501)

**Investor Incentives** Investors who invest by the Closing Date will receive the following incentive:

**Discount or**

**Warrants**

25% Warrant Coverage

**Stock Options**

The company will increase the authorized pool of options prior to the financing to bring the total unallocated options to at least the following percent

Total Unallocated options

24%

in the post money

New options issued

200,000

**Comment [D4]:** One must be careful with discounts, especially when coupled with a liquidation preference. Since the final docs will likely define the liquidation preference in terms of price per share, the discount given here will increase the liquidation preference. For example, a 20% discount will mean a 0.25x increase in the liquidation preference.

**Comment [DR5]:** Discounts or Warrants are an incentive to invest. If granted, it is almost always one or the other, but not both. They must be considered with the price per share as to their reasonableness to current market conditions. It is, of course, cleaner to just lower the price per share, but often there are reasons (e.g. a higher priced friends and family round) not to do so.

**Comment [DR6]:** With warrant coverage, the post money will technically be higher than the pre-money plus the amount invested, because these shares are issued. In reality, given that the warrants are usually priced the same as the shares issued, they are "out of the money" and therefore do not actually effect the post money.

**Comment [DR7]:** The unallocated option pool depends largely on the state of the company's current management team and positions that still need to be filled. This usually ranges from about 10% to 25%, and must be considered in the post-money cap table, not the pre-money cap table.

**Pre and Post-Financing Capitalization (assuming all shares issued)**

Type of stock	Pre-Financing		Post Financing	
	Number of shares	% Fully Diluted	Number of shares	% Fully Diluted
Common	1,000,000	51%	1,000,000	35%
Stock Options Granted	250,000	13%	250,000	9%
Pre-financing Stock Options Avail	500,000	26%	500,000	17%
New Stock Options	200,000	10%	200,000	7%
Series A Pfd Stock			731,250	26%
Warrants			182,813	6%
<b>Total Shares</b>	1,950,000	100%	2,864,063	100%

**Comment [DR8]:** Note that the post money price is more than the pre-money + new money, because of the warrants, which go into the post.

## Terms of the Series A Stock

### Liquidation Preference

**1x participating preferred.** The Series A Preferred shall receive an amount equal to **one times (1x)** the Purchase Price, plus any declared and unpaid dividends, prior to the payment of any sums to any other equity security holders in the event of (i) a liquidation, dissolution, or winding up of the Company; or (ii) "Change in Control," which means a merger or consolidation (other than one in which the stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) and a sale, lease, transfer, or other disposition of all or substantially all of the assets of the Company. Thereafter, all of the proceeds shall be ratably distributed to the holders of Preferred and Common Stock, on an as converted basis.

**Comment [DR9]:** In the past, it was often argued that Angels should not request 1x participating preferred without a cap, because larger follow-on rounds would then get the same. While a small angel round doesn't change the "liquidation overhang," a large VC round might. Capping the liquidation preference in future, larger rounds does make sense.

**Comment [D10]:** Note that this number might be higher for those investors who invested with a discount, even if the doc says 1x

### Dividends

**Dividends only when declared, and not cumulative.** The holders of Series A Preferred will be entitled to receive dividends only when and if declared by the Board and in preference to holders of Common Stock.

**Comment [DR11]:** Cumulative dividends do make sense in the case of a redemption provision, as outlined below.

### Voting Rights

Except as set forth in "Protective Provisions" below, the Series A Preferred shall vote together with the Common Stock on an as converted to Common Stock basis, and not as a separate class

**Comment [DR12]:** Depending on the circumstances, having all of the directors selected by the closing might not be possible. This could read that within XXX days of closing, with the agreement of the Series A director, this can be delayed.

### Board Participation

The holders of a majority of the Series A Preferred shall be entitled to elect one member of the board of directors, who shall initially be [REDACTED]. **At the time of the closing of this financing, the board of directors shall be 5 members: 1 from management, 1 from Series A, and 3 independent directors acceptable to both common and Series A directors.** The Series A

**Comment [DR13]:** Note that five is an arbitrary number and should be adjusted to the circumstances. The goal is to provide excellent guidance to the entrepreneur and bring the investors' knowledge to bear. Often an initial board of 3 is sufficient.

**Comment [DR14]:** It is also reasonable that the Series A director be on compensation committee and must agree to executive compensation.

director shall be compensated with stock options on a standard basis.

**D&O Insurance**

Prior to the closing, the company shall obtain a Directors & Officers insurance policy that is at least \$1M.

**Comment [DR15]:** This amount is a minimum, but generally adequate for a seed stage company. If there is a large amount of investment, real property, or intellectual property, it should be more.

**Conversion Rights**

The holders of the Series A Preferred shall have the right to convert the Series A Preferred into shares of Common Stock at any time. The initial conversion rate for the Series A Preferred shall be 1-for-1, subject to adjustment as indicated below.

**Automatic Conversion**

The Series A Preferred shall automatically be converted into Common Stock, at the then applicable conversion rate, upon: (i) the closing of a firmly underwritten public offering of not less than \$25,000,000 (before payment of underwriters' discounts and commissions) (a "Qualified IPO"); or (ii) the written consent of holders of the majority of the outstanding preferred stock.

**Antidilution Rights**

**Broad based weighted average.** The conversion price of the Series A Preferred will be subject to proportional adjustment for stock splits, stock dividends, and the like, and to adjustment on a broad-based weighted average basis for issuances at a purchase price less than the then-effective conversion price, subject to customary exclusions.

**Founder's Stock Right of Repurchase**

Common stock owned by any founder with more than 2% of the post financing equity is subject to the right of repurchase by the company at the lower of (a) the fair market value (FMV) at the time of agreement or the FMV at the time of repurchase; or (b) \$0.01 per share (if no FMV has been determined), if the founder leaves the company within the first four years. Such a right expires over four years on a monthly basis after the Initial Closing (2.083% per month for 48 months).

**Comment [DR16]:** This percentage can be modulated depending on the circumstances; 2-10% is the reasonable range..

**Comment [DR17]:** This is an important term that is often missing in Angel term sheets. In essence, it converts the founders shares to restricted shares. Having 100% of the founders' shares subject to right of repurchase is a term that can be negotiated. Depending on the state of the company and the value contributed to date, and the value of the founder to the company, this number can be set at less than 100%. However, sufficient shares should be subject to this right to ensure that the founders are bound to the company.

**No Severance**

There are currently no employee severance agreements in place and the company agrees that none will be implemented without Board approval, including approval of the Series A director.

Note that sometimes the founders have invested capital as well as sweat equity. In those cases, the "purchased shares" should be excluded from this provision.

**Comment [D18]:** Washington State law makes employee salary a responsibility of the board of directors. Severance agreements (while in many states seem to be a debt obligation) in WA are often considered a salary obligation, even if they are granted to an executive, who is also on the board. They should be negotiated away.

**Protective Provisions**

In addition to general voting, holders of a majority of the outstanding Series A Preferred shall be required to approve (i) the creation of any senior or *pari passu* security (including the incurrence of debt), (ii) any adverse change to the rights, preferences and privileges of the Series A Preferred Stock, (iii) any merger or consolidation or sale or other disposition of all or substantially all of the assets, (iv) any acquisitions made by the Company, (v) amendment to the articles of incorporation, (vi) issuances of stock options (or stock or similar rights) to employees, consultants or directors in excess of those currently issued or reserved for issuance under existing plans, (vii) any change to the size of the Board of Directors, (viii) dividends or share repurchases/redemptions, (ix) exclusively license the Company's intellectual property, (x) any change in the Company's primary line of business.

**Drag Along Rights**

If the Company's Board of Directors, including the Series A Director, and a majority-in-interest of the holders of Series A Preferred and Common approve a Change of Control Transaction or issuing New Securities, each Holder agrees (i) to vote all shares held by such Holder in favor of such Change of Control Transaction or issuing New Securities, and (ii) to sell or

**Comment [DR19]:** In order to ensure flexibility and rapid decision making, once a majority of the common and preferred A shareholders agree to a decision, getting the others to agree is a meaningless exercise. So, notification, rather than the complete vote is all that is required. This term can be important in WA law, where if not otherwise specified, the number is 2/3 and not a simple majority.

**Comment [DR20]:** Some favor a 60% or 2/3<sup>rd</sup> vote. While more protective of investors, it can put a company into a position where it can't move forward.

exchange all shares of Common Stock then held by such Holder pursuant to the terms and conditions of such a transaction.

**Tag Along Rights**

Any third party offer to acquire (i) any shares of capital stock of the Company from any founder or (ii) at least 50% of the issued and outstanding capital stock of the Company (whether by direct purchase, merger, share exchange or otherwise), must include an offer to acquire all of the outstanding Series A Preferred. Each non-selling holder of Series A Preferred shall have the right (the "Tag-Along Right") to sell to the proposed buyer all, but not less than all, of the Series A Preferred owned by any such holder.

**Comment [D21]:** Tag Along rights prevent a founder or other voting group from selling shares to a third party without including all of the holders of the Series A shares. There are other provisions that can preclude sales but this allows an additional alternative to either precluding a sale or forcing a repurchase by the Company or other stockholders.

**Registration Rights**

The holders of Series A Preferred will be entitled to receive registration rights *pari passu* with and substantially the same as any registration rights granted to holders of equity securities of the Company in the next round of financing of the Company.

**Rights of First Offer**

**Keep pro rata share.** Each Investor who purchases at least \$25,000 of Series A Preferred will have a right of first offer, subject to certain limitations, to purchase its pro rata portion of any new equity securities offered by the Company, subject to standard exclusions. The right of first offer will terminate immediately prior to the earliest to occur of: (i) the Company's initial public offering; (ii) such time as the Company otherwise becomes subject to the reporting provisions of the Securities and Exchange Act of 1934, as amended; or (ii) a Change in Control. This right expires for any investor who does not exercise this right at each opportunity.

**Proprietary Information and Inventions Agreements**

The Company will cause each person previously, now, or hereafter employed or engaged as a consultant to enter into an acceptable proprietary information and inventions agreement.

**Information Rights**

The Company will share with the <<AoA Investors>> (i) audited annual financial statements no later than 90 days after the end of each fiscal year, (ii) unaudited quarterly financial statements no later than 45 days after the end of each quarter and a comparison of such quarter's results with the results projected by the Company's annual budget, (iii) unaudited monthly financial statements no later than 30 days after the end of each month and a comparison of such quarter's results with the results projected by the Company's annual budget, and (iv) an annual budget for the upcoming fiscal year promptly following approval by the Board. <<AoA Investors>> will be entitled to standard rights to inspect the properties and the books and records of the Company at reasonable times and upon reasonable notice to the Company. The obligation of the Company to furnish such information and to permit such inspection will terminate at the earliest of such time as the Company consummates a Qualified IPO, becomes subject to the reporting provisions of the Securities Exchange Act of 1934, as amended, or the closing of a Change of Control.

**Comment [DR22]:** Best practice is that the Company CEO sends out a quarterly letter or holds a meeting with investors at least quarterly to update them on progress, plans, and future financings. General rule – no surprises.

**Comment [DR23]:** Audits can be expensive, especially for a company that is early in its development. It is OK to allow the board to waive this requirement for a period of time.

**Comment [DR24]:** Some favor making this 120 days to save money.

**Qualified Small Business Stock**

Company will make representations and warranties, as of the closing date, that it is a "qualified small business corporation" (QSBC) for purposes of Section 1202 of the Internal Revenue Code and that the Series A Shares are eligible for the gain exclusion provided by Section 1202 if the holding period and other requirements are met by the investor. The Company will make reasonable commercial efforts to maintain this QSBC status.

**Comment [D25]:** As of 3/2013, Section 1202 allows for 100% exclusion of capital gains (up to \$10M or 10x basis, including 100% exclusion of AMT. The stock must be (a) in a domestic C Corp; (b) held 5 years; (c) assets under \$50M at issuance; (d) no significant redemptions.

**Comment [D26]:** The final deal docs need to reflect the commitment by the company not to do significant redemptions: <5% of company stock in a 2 year window, starting 1 year before the purchase, and <2% from any shareholder in a four year window starting 2 years before the purchase. Also >80% of the assets must be used in active conduct of the business.

**Comment [DR27]:** This is a term that is particularly useful for an Angel deal, where capital requirements are low and anticipated cash flow might be high. In those cases, the entrepreneurs might choose to award themselves high salaries and bonuses, stripping the company of cash (which could go to dividends) and find that a sale is less attractive. The investors need a mechanism to force this issue.

In growth investments, this kind of hammer might cause the company to not invest in growth to ensure that they can meet the redemption provision, so it must be used carefully.

**Investor's Counsel**

Company agrees to pay \$5,000 (or \$5,000 per each \$1M, or fraction thereof, raised) for Investors' Counsel expenses to review this term sheet and ensure that the final agreement reflects the terms agreed.

**Redemption Rights (used only if the Company is or might be a "lifestyle business")**

After five years, if not previously converted, the Series A Preferred Stock is to be redeemed in three equal successive annual installments beginning <<Date>>. Redemption will be at the purchase price plus a <<4-12%>>% per annum cumulative return.

**Comment [DR28]:** This percentage needs to be adjusted for the circumstances. It needs to be sufficient to give the investor a reasonable return, if the entrepreneur wants to maintain the business as a "lifestyle business," but not so high as to make the company ill-liquid.

**Due Diligence**

The transactions contemplated by this Term Sheet are subject to the satisfactory completion of due diligence by each Investor.

**Expiration of Letter:**

This letter expires at 5 p.m., Pacific Daylight Time, <<Date>>, unless the Company executes it below and returns an original or faxed executed version to <<AoA Investors>> by that time.

**Exclusivity:**

From the date of acceptance of this Memorandum of Terms until the earliest to occur of (a) consummation of the financing, (b) the formal termination of negotiation by both <<AoA Investors>> and Company or (c) <<Date>>, the Company will not directly or indirectly solicit, initiate or participate in any discussions or negotiations with, or encourage or respond to any inquiries or proposals by any persons, company or group other than the Investors, concerning any financing or sale of the Company without prior approval of <<AoA Investors>>. The Company will promptly notify <<AoA Investors>> if any person, company or group seeks to initiate any other discussions or negotiations and contemplated in the immediately preceding paragraph, makes any proposal or inquiry, or requests any information with respect to any proposed financing or sale of the Company.

**Comment [DR29]:** This provision is not generally recommended nor necessary. This is not generally part of an angel term sheet, but some more sophisticated Angels do not want their terms "shopped" to others. It is included for completeness.

**Confidentiality:**

This term sheet is confidential to the parties and is for the use of the Company's management and their advisors. Accordingly, the information contained in this document may not be disclosed to any third party or used to facilitate negotiations with any third party without <<AoA Investor>>'s and the Company's prior

approval.

**Not an Offer**

This Term Sheet is not a complete description of the financing and does not constitute either an offer to sell or an offer to purchase securities.

**On Behalf of the Company:**

**On Behalf of the Investors:**

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\_\_\_\_\_

Name of Company

Investor Group (if applicable)

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Signature

Signature

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