

Best Practices for Corporate Venture Capital and Strategic Investment Programs

Program Outline

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Panelists:

- Joshua Hess, Assistant General Counsel - Corporate and Strategic Transactions, Capital One
- Daniel Kahan, Partner, King & Spalding
- Thomas Knox, Partner, King & Spalding
- Riana Studner, Associate General Counsel, Director, Lockheed Martin

Agenda:

- VC and CVC Overview
- CVC Governance and Structure
- Investment Terms
- Risk Mitigation
- Exit Planning

I. VC and CVC Overview

A. What is Venture Capital (VC)?

- Investments in startup companies, typically by professional investment managers
- VC goals:
 - Financial return
- Typical structure:
 - Preferred stock sold at a fixed price, based on an agreed equity value
 - Stockholder agreements include special rights and protections for VC investors, including all or some of the following:
 - information rights
 - voting/veto rights
 - registration rights
 - Board nomination rights
 - pro rata participation rights
 - antidilution adjustments
- Other structures:
- Convertible debt
- Other convertible securities (e.g., SAFEs, warrants)

B. What is Corporate Venture Capital (CVC)?

- Investment in startup companies by established companies
- Investments focus on both strategic/commercial and financial goals
- CVC goals:

- Increase sales and profits of the parent entity's business by strengthening commercial partners
- Obtain deeper insight with respect to new technologies
- Gain exposure to new talent
- Enter new markets
- Identify acquisition targets (and exclude competitors)
- Company goals:
 - Gain industry expertise
 - Build commercial partnership to facilitate product development and scaling
 - Boost credibility and positive PR
 - Develop potential exit opportunity

C. Key Differences with Financial VC

- Greater variety of positive investment outcomes
- Lower level of control sought with respect to governance
- Not subject to typical 10-year VC fund structure
- Relatively limited financial exposure
- Focus on side letter agreement vs. primary financing documents
- Often (but not always) paired with a commercial agreement

D. Overview of CVC Trends

II. CVC Governance and Structure

A. CVC Program Organization

- CVC program structuring
 - Separate funds vs. off-balance sheet
 - Separate VC program vs. part of corporate development (i.e., M&A group) or IP development (i.e., the commercial team)
 - Entity considerations
- Key features of a CVC program
 - Investment decision-making process and authority
 - Is there an IC? If so, how is the IC composed?
 - Allocation of capital to the CVC program
 - Calibrating focus on ROI vs. commercial goals
 - Determining strategic relevance of investments
 - Compensation arrangements
- How structure impacts investment process/company relationships

III. Investment Terms

A. Typical VC Financing Terms

- Economic

- Dividends
- Liquidation preference
- Antidilution protection
- Pro rata rights
- Registration rights
- Rights of first refusal on secondary transfers
- Information
 - Monthly, quarterly, annual reporting
 - Inspection rights
 - KPI reporting
 - Other “reasonable requests”
- Governance
 - Board seat and/or board observer
 - Protective provisions
 - Board approval requirements

B. Typical VC Financing Documents (*See Appendix A*)

- Stock Purchase Agreement
- Certificate of Incorporation
- Investors’ Rights Agreement
- Voting Agreement
- Right of First Refusal and Co-Sale Agreement
- Others:
 - Letter agreement (mostly addressing ERISA-related items) (*See Appendix B*)
 - Director indemnification agreement
- Similar structure for CVC investments, with focus on specific provisions and on side letter

C. Key CVC Side Letter Terms

- Basic information rights
- “Major Investor” status
- Public announcements
- Not a “Competitor”
- Right to conduct activities
- Board observer
- M&A rights
- Rights with respect to competitor financings
- Rights with respect to competitor commercial transactions
- RFP rights
- Branding
- MFNs
- Compliance / regulatory covenants
- Put rights

- Drag-along carve-outs (*preferably included in Voting Agreement*)
- Extended survival periods
- Residuals clause

D. IP Disclosure and Contamination

- Both CVCs and companies must address issues regarding the disclosure of technical IP and strategic competitive and business information during due diligence and post-investment
 - CVCs: need to preserve freedom to operate and limit risk exposure to trade secret misappropriation or breach of fiduciary duty claims
 - Companies: need to protect confidential information, IP and strategic plans
- Key Considerations
 - Definitions of “competitor” in primary financing documents
 - Limiting receipt of competitively sensitive information to a “clean team”
 - Protecting competitively sensitive information contained in company documents (e.g., pricing/fee information)
 - Use of Board observers vs. directors – and choice of the designee
 - Excluding Board observers from portions of Board meetings
 - Residuals clauses

E. Exclusivity and Notice Rights

- CVCs want exclusivity or visibility with respect to transactions with competitors
 - Both a strategic/financial and optics issue
- Companies want to limit restrictive exclusivity and negotiation rights, which may drive away third-party bidders or lower valuations with respect to M&A, commercial and financing opportunities
 - Note that financial investors will be aligned with companies on this
- Key Considerations
 - Scope of exclusivity and notice rights
 - Type of right: ROFRs, ROFNs, Branding rights and MFNs
 - Type of transaction: M&A, equity financings, commercial transactions or RFPs
 - Level of information disclosed: bidder name, price, other key terms, etc.
 - Veto rights over exits
 - Negotiating with multiple CVCs who want equivalent rights

F. Deal Timing

- CVC investment thesis is predicated on the development of a commercial relationship, but the timing of entering into commercial agreement may not align with the financial investment
- Other than waiting to close, options to mitigate include:
 - Agreement to key commercial terms in an attached side letter or MOU, with an obligation to continue to negotiate in good faith post-closing

- Partially fund, with the remainder paid when the commercial agreement is reached and/or commercial milestones are met
- Right to put the equity investment into debt if the commercial agreement is not reached by agreed time – or have the investment be redeemed entirely
- Right to cause the Company to facilitate a secondary sale if the commercial agreement is not reached
- Fund with convertible debt that automatically converts into equity when the commercial agreement is reached or converts at the CVC’s election at a pre-negotiated conversion price

IV. Risk Mitigation

A. Risk Mitigation Concerns

- Potential reputational damage to CVC investor may (greatly) outweigh total financial investment
- Key compliance risk areas include:
 - Anti-bribery, anti-corruption and anti-money laundering
 - Data privacy and data security
 - Business dealings with sanctioned entities or countries
 - #metoo issues
 - Jurisdiction-specific issues (e.g., local workers’ rights laws)
 - Tech industry scrutiny
 - Thin line between founder puffery and fraud
- Highly regulated investors (e.g., banks, insurance companies, government contractors) have additional, specific issues to consider

B. Risk Mitigation Techniques

- Due diligence
 - Business, financial, legal
 - Functional area (e.g., IT, privacy, export)
- Investment documents
 - Include compliance-focused representations, warranties and covenants
- Quick path to exit
 - Put right (e.g., ability to put 100% of the investment to the Company for FMV or \$1.00)
- Stay informed
 - Negotiation of information rights and/or Board designation/observer rights
- D&O matters
 - Ensure adequate insurance and indemnification arrangements are in place if CVC is represented on the Board
- Regulatory provisions
 - Include confidentiality carve-outs for regulatory oversight/exams; cooperation covenants; specialized representations and covenants for compliance with specific laws

C. Board Service

- Director obligations
 - Duty of loyalty
 - Duty of care
 - Practical concerns:
 - Attentiveness
 - Conflicts
 - Confidentiality
- Board observer
 - Contractual confidentiality obligations
 - De facto director doctrine (*Prickett v. Am. Steel & Pump Corp.*, 253 A.2d 86, 88 (Del. Ch. 1969))
- Indemnification
 - Indemnification agreements (with appointing stockholder indemnity) are customary
 - Early-stage companies may have very little D&O coverage

V. Exit Planning

A. Thinking Ahead for Exit Transactions

- Planning for positive scenarios:
 - Acquisition by CVC parent
 - Acquisition by competitor or other strategic buyer
 - Acquisition by private company (stock consideration)
 - SPAC combination
 - IPO/direct listing
 - Secondary sales
- Planning for distressed scenarios:
 - Acqui-hire/fire sale
 - Forced divestment (e.g., by regulator)
 - Liquidation/winding up
- Disclosure considerations for public company CVCs
- Special considerations for CVC directors
 - Disclosure of conflicts
 - Recusal/resignation
 - Use of committees
 - Reliance on advisors

* * *

Appendix A

National Venture Capital Association Model 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 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). For Series B and later transactions, consider substantially shortening to refer to deal terms being “consistent with prior rounds, subject to reasonable review by Lead Investor” (as noted in the prior sentence, deal terms often are negotiated further between term sheet and closing, so relying on a term sheet for one round in a later round may prove inaccurate).

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 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 the conditions to closing set forth below. This Term Sheet shall be governed in all respects by the laws of [_____].¹

Offering Terms

- Security:* Series A Preferred Stock (the “**Series A Preferred**”).
- 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]*
- Conditions to Closing:* Standard conditions to Closing, including, among other things, satisfactory completion of financial and legal due diligence,

¹ Because a “nonbinding” term sheet governed by the law of a jurisdiction such as Delaware, New York or the District of Columbia may in fact create an enforceable obligation to negotiate in good faith to come to agreement on the terms set forth in the term sheet, parties should give consideration to the choice of law selected to govern the term sheet. Compare *SIGA Techs., Inc. v. PharmAthene, Inc.*, Case No. C.A. 2627 (Del. Supreme Court May 24, 2013) (holding that where parties agreed to negotiate in good faith in accordance with a term sheet, that obligation was enforceable notwithstanding the fact that the term sheet itself was not signed and contained a footer on each page stating “Non Binding Terms”); *EQT Infrastructure Ltd. v. Smith*, 861 F. Supp. 2d 220 (S.D.N.Y. 2012); *Stanford Hotels Corp. v. Potomac Creek Assocs., L.P.*, 18 A.3d 725 (D.C. App. 2011) with *Rosenfield v. United States Trust Co.*, 5 N.E. 323, 326 (Mass. 1935) (“An agreement to reach an agreement is a contradiction in terms and imposes no obligation on the parties thereto.”); *Martin v. Martin*, 326 S.W.3d 741 (Tex. App. 2010); *Va. Power Energy Mktg. v. EQT Energy, LLC*, 2012 WL 2905110 (E.D. Va. July 16, 2012).

qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, [obtaining CFIUS clearance and/or a statement from CFIUS that no further review is necessary,]² [and an opinion of counsel to the Company].³

Investors: Investor No. 1: [] shares ([]%), \$[]

Investor No. 2: [] shares ([]%), \$[]

[as well other investors mutually agreed upon by Investors and the Company]

*Amount Raised:*⁴ \$[], [including \$[] from the conversion of SAFEs/principal [and interest] on bridge notes].⁵

Pre-Money Valuation: The price per share of the Series A Preferred (the “**Original Purchase Price**”) shall be the price determined on the basis of a fully-diluted pre-money valuation of \$[] (which pre-money valuation shall include an [unallocated and uncommitted] employee option pool representing []% of the fully-diluted post-money capitalization) and a fully-diluted post-money valuation of \$[].

CHARTER

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:* 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 of Directors.]

[*Alternative 3:* The Series A Preferred will carry an annual []% cumulative dividend [payable upon a liquidation or

² To be included if the parties review the facts of the investment and determine that a CFIUS filing is warranted. Where a mandatory filing is necessary, that filing must be submitted 45 days in advance of closing, but obtaining CFIUS clearance in advance of closing is not a requirement of law. However, submitting a CFIUS filing and then closing before the review process is completed creates regulatory risks for all parties that are best avoided if the timing of the investment permits.

³ See NVCA Model Legal Opinion for detailed commentary on legal opinions.

⁴ This provision would have to be modified for staged investments or investments dependent on the achievement of milestones by the Company.

⁵ Convertible instruments that convert at a discount may provide for a “shadow” or “subseries” of Preferred that is identical to the new round security except with respect to the amount received on liquidation, so that in a downside exit scenario all investors are at best only getting their money back. Be clear in the term sheet whether the shares issued on conversion are part of the pre-money capitalization or post-money capitalization.

redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.]⁶

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 [__ times] the Original Purchase Price [plus [accrued and] declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock.]

[Alternative 2 (full participating Preferred Stock): First pay [__ times] the Original Purchase Price [plus accrued and 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 [__ times] the Original Purchase Price [plus accrued and 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 the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) or 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 [__]%⁷ of the Series A Preferred elect otherwise (the “**Requisite Holders**”). [The Investors’ entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to

⁶ 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, which are quite rare in this context.

⁷ Careful thought should be given to the voting threshold based on the makeup of the round, especially if multiple series/classes are implicated. Also bear in mind that anti-dilution adjustments may result in changes in voting power.

escrow or indemnity holdback in connection with a Deemed Liquidation Event.]⁸

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 %*] of the shares of Series A Preferred issued in the transaction are outstanding, the Series A Preferred as a separate class shall be entitled to elect [_____] [()] members of the Board of Directors ([each a] “Preferred Director”), (ii) as required by law, and (iii) as provided in “Protective Provisions” below. The Company’s Charter 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.⁹

Protective Provisions:

So long as [*insert fixed number or %*] shares of Series A Preferred issued in the transaction are outstanding, in addition to any other vote or approval required under the Company’s Charter or Bylaws, the Company will not, without the written consent of the Requisite Holders, either directly or by amendment, merger, consolidation, recapitalization, reclassification, or otherwise:

- (i) liquidate, dissolve or wind-up the affairs of the Company or effect any Deemed Liquidation Event;
- (ii) amend, alter, or repeal any provision of the Charter or Bylaws [*in a manner adverse to the Series A Preferred Stock*];
- (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security unless the same ranks junior to the Series A Preferred with respect to its rights, preferences and privileges, or increase the authorized number of shares of Series A Preferred;
- (iv) sell, issue, sponsor, create or distribute any digital tokens, cryptocurrency or other blockchain-based assets without approval of the Board of Directors[, including the Investor Directors];
- (v) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, other than stock repurchased at cost from former employees and consultants in connection with the cessation of their service, [or as otherwise approved by the Board of Directors[, including the approval of [at least one] Preferred Director];
- or (vi) [adopt, amend, terminate or repeal any equity (or

⁸ See Section 2.3.4 of the Model Certificate of Incorporation for an explanation of this provision.

⁹ 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 DGCL 242(b)(2). If (contrary to the protective provisions in this Term Sheet) the Preferred Stock is *not* intended to be able to block future financings, include a 242(b)(2) waiver for the Preferred Stock as well.

equity-linked) compensation plan or amend or waive any of the terms of any option or other grant pursuant to any such plan; (vii)]¹⁰ create or authorize the creation of 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, bank lines of credit or trade payables incurred in the ordinary course] [unless such debt security has received the prior approval of the Board of Directors, including the approval of [at least one] Preferred Director; [or](viii) create or hold capital stock in any subsidiary that is not wholly-owned, or dispose of any subsidiary stock or all or substantially all of any subsidiary assets; [or (ix) increase or decrease the authorized number of directors constituting the Board of Directors or change the number of votes entitled to be cast by any director or directors on any matter].

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:

$$CP_2 = CP_1 * (A+B) / (A+C)$$

Where:

CP₂ = Series A Conversion Price in effect immediately after new issue

CP₁ = 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)¹¹

B = Aggregate consideration received by the Company with respect to the new issue divided

¹⁰ See footnote in model charter.

¹¹ The most broad based formula would include shares reserved in the option pool; a narrower base would exclude options or other convertibles. The formula above is the most typical.

by CP₁
C = Number of shares of stock issued in the subject transaction

The foregoing shall be subject to customary exceptions, including, without limitation, the following:

(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; (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 [one] Preferred Director(s)], and other customary exceptions¹².

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]¹³ (subject to adjustments for stock dividends, splits, combinations and similar events) and [gross] proceeds to the Company of not less than \$[] (a "QPO"), or (ii) upon the written consent of the Requisite Holders.

[Pay-to-Play:

Unless the Requisite Holders elect otherwise, on any subsequent [down] round all holders of Series A Preferred Stock are required to purchase their pro rata share of the securities set aside by the Board of Directors for purchase by such holders. [A proportionate amount/all] of the shares of Series A Preferred of any holder failing to do so will automatically convert to Common Stock and lose corresponding preferred stock rights, such as the right to a Board seat if applicable.

¹² See Sections 4.4.1(a)(v)-(viii) of the Model Certificate of Incorporation for additional exclusions; consider building into the term sheet to avoid later "negotiation".

¹³ The per share price floor generally benefits small/minority holders. Consider 1) 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 such Investor does not have the power to block an IPO and 2) whether IPO proceeds alone should be sufficient to establish the minimum requirements for an IPO that triggers conversion.

*[Redemption Rights:]*¹⁴

Unless prohibited by applicable law governing distributions to stockholders, the Series A Preferred shall be redeemable at the option of the Requisite Holders commencing any time after the five (5) year anniversary of the Closing at a price equal to the Original Purchase Price [plus all accrued/declared 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)].

STOCK PURCHASE AGREEMENT

Representations and Warranties:

Standard representations and warranties by the Company customary for its size and industry. [Representations and warranties regarding CFIUS.]¹⁵

[Regulatory Covenants (CFIUS):

To the extent a CFIUS filing is or may be required: Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States (“CFIUS”) and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties’ [notice/declaration]].¹⁶

¹⁴ Redemption provisions are rare and even more rarely exercised. If included, note that 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 Certificate of Incorporation), investors may seek enforcement provisions to give their redemption rights more teeth - e.g., the holders of a majority of the Series A Preferred shall be entitled to elect a majority of the Company’s Board of Directors, or shall have consent rights on Company cash expenditures, until such amounts are paid in full. Also, while it is possible that the right to receive dividends on redemption could give rise to a DGCL 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.

¹⁵ To be considered in order to address issues under the Defense Production Act of 1950 and related regulations (DPA). Relevant representations may include whether or not a company works with “critical technologies” within the meaning of the DPA, whether a company has operations or activities in particular sectors of the U.S. economy or in the U.S. at all, whether a Company stores or maintains certain types of data, whether an Investor is foreign, and whether an Investor has foreign government relationships, among others.

¹⁶ To be included if Investors review the facts of the investment and determine that a CFIUS filing is warranted. When the Investors are foreign persons, a CFIUS filing may be mandatory with respect to certain investments (e.g., some transactions involving “critical technologies”), and voluntary but advisable with respect to others. This covenant may be paired with an explicit reference to the exercise of the redemption right in the Charter in the event of a CFIUS-mandated divestiture of shares. A CFIUS “notice” is a full-form filing that results in a definitive opinion by CFIUS regarding the national security risks associated with the transaction, but may take months to obtain; a CFIUS “declaration” is a short-form filing that may not result in a definitive opinion by CFIUS but is intended to be able to be obtained within 45 days. If a CFIUS filing is warranted, the parties may also elect to negotiate a basic statement laying out the scope of Investors’ obligation to accept CFIUS conditions (e.g., will Investors be obligated to accept conditions or restriction as a condition of CFIUS clearance that would have a material adverse impact on the

Counsel and Expenses: [Company] counsel to draft applicable documents. Company to pay all legal and administrative costs of the financing [at Closing], including (subject to the Closing) reasonable fees (not to exceed \$[____]) and expenses of 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**.”¹⁷

Demand Registration: Upon earliest of (i) [three (3)-five (5)] years after the Closing; or (ii) [six (6)] months following an initial public offering (“**IPO**”), persons holding [__]%¹⁸ 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]¹⁹ 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 offering price of at least \$[3-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [two (2)] per twelve (12) month period.

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

Investors?). Whether or not a CFIUS filing is made, the parties may wish to consider other risk allocation measures or terms; examples include unilateral or bilateral waivers of responsibility for CFIUS-related costs and penalties, indemnification terms, or other similar language.

¹⁷ Although not typical, founders/management may sometimes be granted limited registration rights.

¹⁸ 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.

¹⁹ A percent threshold may not be necessary in light of the dollar threshold.

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 \$[_____] per registration, 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 held immediately before the effective date of the IPO for a period of up to 180 days 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 [in which similar rights are granted or the consideration payable to Investors consists of cash or securities of a class listed on a national exchange]] [and/or after the IPO, when the Investor and its Rule 144 affiliates holds less than 1% of the Company's stock and all shares of an Investor are eligible to be sold without restriction under Rule 144 and/or] [T][t]he [third-fifth] 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 requires one.²⁰

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 of Directors; [and] (ii) thirty days prior to the end of each fiscal year, a comprehensive

²⁰ See commentary in introduction to Model Managements Rights Letter, explaining statutory basis of such letter.

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 and shares issued in an IPO). 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 Preferred Director Approval:

So long as the holders of Series A Preferred are entitled to elect a Director, the Company will not, without Board approval, which approval must include the affirmative vote of [at least one/each of] the then-seated Preferred Directors:

(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 an 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 of Directors]; (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) hire, fire, or change the compensation of the executive officers, including approving any option grants; (vii) change the principal business of the Company, enter new lines of business, or exit the current line of business; (viii) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (ix) enter into any corporate strategic relationship involving the payment

contribution or assignment by the Company or to the Company of assets greater than [\$_____].]

*Non-Competition Agreements:*²¹

Founders and key employee will enter into a [one] year non-competition agreement in a form reasonably acceptable to the Investors.

Non-Disclosure, Non-Solicitation and Developments Agreement:

Each current, future and former founder, employee and consultant will enter into a non-disclosure, non-solicitation and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.

Board Matters:

[Each Board Committee/the Nominating and Audit Committee shall include at least one Preferred Director.] Company to reimburse [nonemployee] directors for reasonable out-of-pocket expenses incurred in connection with attending Board meeting. 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] Preferred Director with provisions benefitting their affiliated funds in form acceptable to such director. In the event the Company merges with another entity and is not the surviving entity, 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.

Employee Stock Options:

All [future] employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months].

[Limitations on Pre-CFIUS-Approval Exercise of Rights: 22

Notwithstanding anything to the contrary contained in the Transaction Agreements, Investors and the Company agree that as of and following the initial Closing and until the CFIUS clearance is received, Investors shall not obtain (i) "control" (as defined in Section 721 of the Defense Production Act, as amended, including all implementing regulations thereof (the "DPA")) of the Company, including the power to determine, direct or decide any important matters for the Company; (ii) access to any material nonpublic technical information (as defined in the DPA) in the possession of the Company;

²¹ 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. Some states (e.g., MA) require additional consideration in exchange for signing and/or enforcing a non-compete. Consider also whether 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.

²² To be included if Investors intend to close the transaction in stages, with at least one stage occurring before CFIUS clearance is obtained. The foreign investor side letter language on point would override any aspect of the other transaction agreements that might, until CFIUS clearance is obtained, grant control of the Company or access to aspects of the Company that might create grounds for CFIUS jurisdiction.

(iii) membership or observer rights on the Board of Directors of the Company or the right to nominate an individual to a position on the Board of Directors of the Company; or (iv) any involvement (other than through voting of shares) in substantive decision-making of the Company regarding (x) the use, development, acquisition, or release of any of the Company’s “critical technologies” (as defined in the DPA); (y) the use, development, acquisition, safekeeping, or release of “sensitive personal data” (as defined in the DPA) of U.S. citizens maintained or collected by the Company, or (z) the management, operation, manufacture, or supply of “covered investment critical infrastructure” (as defined in the DPA). To the extent that any term in the Transaction Agreements would grant any of these rights, (i)-(iv) to Investors, that term shall have no effect until such time as the CFIUS clearance is received.]

*[Springing CFIUS Covenant:]*²³

[In the event that CFIUS requests or requires a filing/in the event of []], Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States (“CFIUS”) and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties’ [notice/declaration]. Notwithstanding the previous sentence, Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors’ right to exercise control over the Company.]

*[Limitations on Information Rights:]*²⁴

Notwithstanding anything to the contrary contained in the Stock Purchase Agreement, the Charter, the Investors’ Rights Agreement, the Right of First Refusal And Co-Sale Agreement,

²³ To be included if Investors believe that there is risk that CFIUS may request a filing of the transaction at some future date or that a CFIUS filing may be required in the event of some future occurrence (*e.g.*, when the exit of another investor causes Investor to obtain control over the selection of a Board member). A springing CFIUS covenant provides certainty that all parties will proceed at CFIUS in orderly fashion. The further “notwithstanding” sentence ensures that while parties will cooperate to make the CFIUS filing, Investor will not be obligated to accept CFIUS-required conditions on the deal that might frustrate the purposes of its investment (*i.e.*, the Investor can abandon the proposed investment); more robust mitigation commitment language may be desirable from the perspective of U.S. companies or U.S. investors seeking to limit foreign investors’ ability to abandon the transaction. For more information on the differences between electing to pursue a CFIUS notice vs. a CFIUS declaration and considering a reference to redemption rights, see footnote 16.

²⁴ To be included if Investors are considered foreign entities under the DPA and intend to make an investment outside the jurisdiction of CFIUS. This assumes that Investors intend not to obtain (i) a Board seat, observer, or nomination right, (ii) more than 10% of the voting rights in the Company, or (iii) control over decision-making at the Company, including with respect to Company technologies, data and infrastructure. If the Stock Purchase Agreements, Charter, and other Transaction Agreements contemplate an investment on those terms, then a disclaimer of information rights with respect to certain technical information should be the last necessary step to remove the transaction from CFIUS jurisdiction. Further markups of the other Transaction Agreements would be necessary to ensure that they are developed consistent with this intention.

and the Voting Agreement (all of the agreements above together being the “**Transaction Agreements**”), Investors and the Company agree that as of and following [Closing/the initial Closing], Investors shall not obtain access to any material nonpublic technical information (as defined in Section 721 of the Defense Production Act, as amended, including all implementing regulations thereof (the “**DPA**”)) in the possession of the Company.]

Other Covenants:

Consult the NVCA Model Investors’ Rights Agreement for a number of other covenants the Investors may seek; Investors should include to the extent they feel any may be controversial if not raised at the Term Sheet stage.

RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT

*Right of First Refusal/
Right of Co-Sale (Take-Me-
Along):*

Company first and Investors second will have a right of first refusal with respect to any shares of capital stock of the Company proposed to be transferred by current and future employees holding 1% or more 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.²⁵

VOTING AGREEMENT

Board of Directors:

At the Closing, the Board of Directors 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 Common Stockholders, (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 other directors²⁶].

[Drag Along:

Holder of Preferred Stock and all current and future holders of greater than [1]% of Common Stock (assuming conversion of

²⁵ 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.

²⁶ Other formulations might be majority of Common then held by employees and majority of Preferred, for example.

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] the Requisite Holders [and holders of a majority of the shares of Common Stock then held by employees of the Company (collectively with the Requisite Holders, 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 Charter, subject to customary limitations.]^{27]}

OTHER MATTERS

[Founders’ Stock:

Buyback right/vesting for []% for first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over following [] months.]²⁸

[Existing Preferred Stock:²⁹

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 and the Investors agree to work in good faith expeditiously towards the Closing. The Company and the founders agree that they will not, for a period of [] days 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. The Company will not disclose the terms of this Term Sheet to any person other than employees, stockholders,

²⁷ See Section 3.3 of the Model Voting Agreement for a list of additional conditions that might be required in order for the drag-along to be invoked.

²⁸ Most founders’ shares are already subject to vesting; consider what level of vesting is appropriate and revise to marry up. Investors may also conclude not to change founder vesting.

²⁹ Necessary only if this is a later round of financing, and not the initial Series A round.

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 (which shall not be unreasonably withheld, conditioned or delayed).

Expiration:

This Term Sheet expires on [_____ __, 20__] if not accepted by the Company by that date.

[Signature Page Follows]

EXECUTED this [] day of [], 20[].

[Signature Blocks]

Appendix B

National Venture Capital Association Model Letter Agreement

[PORTFOLIO COMPANY LETTERHEAD]

[____], 20[____]
[Investor Name]
[Street Address]
[City], [State] [Zip]

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.]¹

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.]²

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

¹ For an investor that is a “foreign person” within the meaning of the regulations of the Committee on Foreign Investment in the United States (“CFIUS”), this provision may need to be removed if the parties intend to ensure that the foreign investor has no rights with respect to the Company that would subject their investment to CFIUS jurisdiction. Examples of such rights include (i) “control” of the Company as that term is broadly defined in the CFIUS regulations, (ii) access to “material nonpublic technical information” in the Company’s possession, or (iii) “involvement” in “substantive decisionmaking” by the Company regarding certain matters as those terms are defined in the CFIUS regulations. Note, however, that the more provisions of this agreement that are removed, the less clear it will be that the VCOC exemption will be satisfied by this MRL. See also footnotes 2-4 below.

² For the same reasons discussed in footnote 1 above, “foreign person” investors and the Company may wish limit this provision so that foreign investors only have the right to receive and examine records relating to “financial information” and similar data regarding the Company’s performance. Extending the foreign investor’s rights to include the more general inspection of facilities and other books and records (*e.g.*, operating budgets, business plans, *etc.*) could implicate information that would trigger CFIUS jurisdiction. Because such limitations will be unappealing to foreign investors, restricting access to financial information alone will likely make sense only where a mandatory CFIUS filing could potentially be triggered if broader access is permitted or where the Company wants to take the strongest possible position against any potential CFIUS jurisdiction.

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.]³

4. [Notwithstanding anything to the contrary in this letter agreement, solely by reason of becoming party to this letter agreement, Investor will not obtain with respect to the Company, and the Company will not provide to Investor, any of the following rights, as defined in Section 721 of the Defense Production Act, as amended, including its implementing regulations: (a) "control" of the Company, including the power to determine, direct or decide any important matters affecting the Company; (b) membership or observer rights on the Board of Directors or equivalent body of the Company, or the right to nominate an individual to a position on the Board of Directors or equivalent body of the Company; (c) access to any "material nonpublic technical information" in the possession of the Company [(provided, however, that such prohibited information shall not include financial information regarding the performance of the Company, and provided further that Investor may confer with the Company about such financial information)]; and (d) any "involvement" (other than through voting of shares) in "substantive decision making" of the Company regarding (i) the use, development, acquisition, safekeeping, or release of "sensitive personal data" of U.S. citizens maintained or collected by the Company, (ii) the use, development, acquisition, or release of "critical technologies," or (iii) the management, operation, manufacture, or supply of "covered investment critical infrastructure."⁴

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.⁵

³ For the reasons discussed in footnotes 1 and 2, this provision may also need to be removed if the parties intend to ensure that a foreign investor has no rights that may subject the investment to CFIUS jurisdiction.

⁴ For an investor that is a "foreign person" within the meaning of the CFIUS regulations, this provision should be included to ensure that the parties are excluding the grant of any rights to that investor that may trigger CFIUS jurisdiction. The bracketed carve-out to this exclusion language clarifies that Investor shall not be prohibited from receiving "financial information" regarding the Company's performance, which is expressly permissible under the CFIUS regulations. Including the financial information carve-out signals that at least limited management rights will be granted to Investor, though the broad limitations on Investor rights in this provision may create concerns with respect to the availability of the VCOC exemption for certain investment plans subject to ERISA, as discussed in the Preliminary Note, above.

Note: As an alternative to a narrow carve-out regarding "financial information," the parties could broaden the carve-out to encompass customary information and inspection rights (e.g., the right to inspect all of the Company's books, records, and facilities) or otherwise to participate in management-related activities related solely to reviewing financial information or other administrative (e.g., non-technical) questions. This alternative approach will limit the protections against CFIUS jurisdiction granted by the provision as a whole, but may present less of an issue with respect to the availability of the VCOC exemption. Because of the inherent tension between the CFIUS and ERISA regimes in this context, Foreign funds with known ERISA concerns should consult counsel before deciding what language to include and exclude in this agreement.

⁵ 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 [(x)] 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 and [(y) in which the successor entity provides reasonably comparable rights to the Investor or the consideration payable to the Investor in such transaction consists solely of cash or securities of a class listed on a national exchange]. The confidentiality obligations referenced herein will survive any such termination.

[Signature Page Follows]

Very truly yours,

[INVESTOR]

By: _____

Name: _____

Title: _____

Agreed and Accepted:

[COMPANY]

By: _____

Name: _____

Title: _____