**CHECKLIST**

**ALTERNATIVE TERM SHEET PROVISIONS**

You can use the following alternative provisions to modify a term sheet depending on whether your company is seeking capital or is investing. Consider the explanations of each provision before integrating it into your Term Sheet Agreement. Remember to ask your lawyer to review it!

**DIVIDEND**

The directors need not pay a dividend unless they wish to pay dividends on Common Stock in the same year. In a scenario more favourable to investors, dividends may be participating (*i.e.*, preferred stockholders to receive additional dividends equal with common stockholders once all preferences have been satisfied) and/or cumulative (*i.e.*, unpaid dividends will be added to the liquidation amount and the redemption price of the preferred stock and all accrued dividends for past, as well as the current year, must be paid prior to payment of dividends on common stock

**LIQUIDATION PREFERENCE**

Alternatively, terms may be structured so that preferred stockholders may get back only their original investment, or they may retain their original investment plus all accrued but unpaid dividends for every year, or they may share the remainder equally on an as-converted basis with common stockholders only after their preferences and all common stock liquidation amounts have been paid. In subsequent financings, new series of preferred stock may have a superior position on liquidation or be on a pari passu footing with this series with respect to liquidation. Liquidation may be defined in the term sheet to include the acquisition of the Company or its merger into another entity, with the classification of such event as a liquidation or not at the investors' option at the time of the merger.

**REDEMPTION**

While going public or an acquisition usually connotes a clear "success’, the investor must also consider the case in which the Company only achieves moderate success and management is content to keep things going as a private Company. According to these terms, the company must redeem at a specified amount which provides investors with some guaranteed return on their investment. Alternatives include: (a) optional redemption after a certain date by either the Company or the investors and (b) a provision stating that the Company may not call the Preferred Stock for redemption nor may the investors require the Company to redeem their stock. If the Company may call the Preferred Stock at its option, it could potentially call once the common price exceeds the redemption price and force the investor to take a mediocre repayment on his investment or convert to common and lose his preferred position in the Company.

**REGISTRATION RIGHTS**

In order to have a public offering, the Company must file a registration statement with the SEC. Because the investor cannot be assured of controlling the Board of Directors of the Company (after all that is what the entrepreneur fears will happen), the investor usually negotiates for "demand registration rights" under which the Company contractually agrees to file a registration statement on the demand of the investor. The number of "demands" is negotiated, with the Company saying that one is enough and the investor arguing for two or more.

Conceptually the granting of demand registration rights is a big deal for the Company because of the time and cost involved if those rights are invoked – it can easily cost R2,800,000 or more to file a registration statement. *In re*ality, it is a rare case when registration is demanded against the desires of management – after all, management has to go on the "road show" and make a good presentation to the mutual fund managers and brokers who will be buying the stock.

In addition, the investor usually receives "piggyback" registration rights under which the investor’s shares are included in any "primary registration" statement (where the company is selling its own stock) or in any "secondary registration" where the Company is filing a registration statement to permit others to sell.

**PRE-EMPTIVE RIGHTS**

This right is typically granted to investors to ensure that the Company does not negotiate new financings with new players without offering to deal with the present investors. Sometimes investors are required to take "all or none" of the new financing.

**AUTOMATIC CONVERSION**

Because the control and other terms of a venture capital preferred are not consistent with public market securities, the Preferred Stock has to “disappear” (*i.e.*, be converted into Common Stock) at the Initial Public Offering.

**ANTI-DILUTION**

Anti-dilution adjustments increase the amount of stock received by an investor if the Company issues additional stock at prices which are lower than that paid by the investor. Because there is no readily ascertainable independent market price for the stock, investors believe that they should be protected against having overpaid. Another rationale is that the entrepreneur should pay if he does not increase the value of the Company by the next round of financing. However, from the entrepreneur's side, a decrease in the value of the Company could result from events beyond the entrepreneur's control- e.g. a change in the law or a stock market crash. Having said this, anti-dilution adjustments are almost always present in one form or another.

Note that the formulae used in these provisions decrease the conversion price of the Preferred Stock resulting in more shares of common stock per share of Preferred Stock upon conversion. The weighted average anti-dilution formula considers the total number of shares being issued as well as the per share price; contract this to the full factor anti-dilution formula which automatically reduces the conversion price to the price at which a new issue is sold, even if only a small number of shares are issued.

**MANAGEMENT OPTIONS**

In determining the “pre-money” valuation of the Company, Investors usually factor the option pool size into their valuation and assume that the full amount of the option pool is taken into account.

**STOCK RESTRICTION AGREEMENT**

Investors will want to ensure that the present management of the Company has an incentive to remain there; rewarding continued work at the Company by appreciation in the value of stock and discouraging the individual's leaving by the buy-back provisions detailed above are effective mechanisms to encourage long-term commitment.