

ANGEL FINANCING: ANNOTATED TERM SHEET

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This term sheet has been prepared assuming a fairly standard preferred stock financing by angel investors for an Oregon corporation. The specific terms of an angel investment will depend on the particular circumstances of both the investors and the enterprise being financed, as well as the general financing environment.

[_____] , INC.
MEMORANDUM OF TERMS FOR THE
PRIVATE PLACEMENT OF
SERIES A PREFERRED STOCK*

Amount to Be Raised: [\$_____]

Type of Security: Series A Preferred Stock ("Series A Preferred").

Pre-Money Valuation: [\$_____]

Total Shares to Be Sold: [_____] shares

Purchase Price: [\$_____] per share (the "Purchase Price")

Investors: Accredited Investors as defined under the Securities Act of 1933.

Post-Financing Capitalization: See Schedule A hereto.

Closing Date: The [first] closing of the sale of the Series A Preferred (the "Closing") will be on or before _____, 2004.

[Second closing: Up to [30-60] days thereafter.]

[COMMENT: Consider whether a single closing can occur. If not, consider creating documents that permit a second or series of subsequent closings that may occur within a specified period. Consider whether the first closing must be subject to a minimum dollar threshold.]

Rights, Preferences, Privileges
and Restrictions of the Series
A Preferred Stock:

Dividends: The holders of Series A Preferred will be entitled to receive noncumulative dividends in preference to the holders of Common Stock or any stock ranking junior to the Series A Preferred at an annual rate of [8]% of the Purchase Price per share from legally available funds when, as and if declared by the Company's Board of Directors. No dividends will be declared or paid on shares of Common Stock or any stock ranking junior to the Series A Preferred unless and until an equal or greater dividend (on an as-converted basis) has been declared and paid on shares of Series A Preferred.

[COMMENT: It is unusual in angel financings to see either a mandatory or cumulative dividend feature. The vast majority of financings carry only dividend protection relative to Common Stock or other junior securities.]

Liquidation Preference: In the event of any dissolution, liquidation or winding up of the Company (a "Liquidation"), the holders of Series A Preferred will be entitled to receive in preference to the holders of Common Stock or any other stock ranking junior to the Series A Preferred, an amount equal to the Purchase Price per share, plus declared and unpaid dividends, if any (the "Initial Payment"). If upon such Liquidation, the assets of the Company are insufficient to distribute in full the Initial Payment to the

holders of the Series A Preferred, then such assets shall be distributed ratably in proportion to the Initial Payment each such holder would otherwise be entitled to receive.

After the Initial Payment has been made in full, any remaining assets of the Company shall be distributed ratably among the holders of the [Common Stock] [Series A Preferred (on an as-converted basis) and the holders of the Common Stock (until the holders of the Series A Preferred have received an aggregate of [_____] times the Purchase Price per share (plus any declared and unpaid dividends included in the Initial Payment))].

[Thereafter, the remaining assets of the Company will be distributed ratably to the holders of the Common Stock.]

A merger, acquisition, share exchange, or other corporate transaction or series of transactions in which the shareholders of the Company immediately prior to such transaction or series of transactions do not own a majority of the outstanding shares and a majority of the voting power of the surviving entity after such transaction or transactions, or any sale, lease or other disposition of all or substantially all of the assets of the Company (each, a "Corporate Event") will be deemed to be a Liquidation for purposes of the liquidation preference.

[COMMENT: The liquidation preference is perhaps one of the most negotiated provisions in a financing. In substantially all cases, the holders of Series A will require that available funds be distributed to them first (and in unusual cases may require more than a 100% preferential return). Thereafter the issue of whether the Series A is "participating" or "non-participating" must be addressed. Participation allows the holders of Series A to share with the holders of common stock on an as-converted basis after the return of the Purchase Price. A "non-participating" feature provides that after a stated priority return of funds, the remaining proceeds are shared ratably only among holders of common stock. Participation is increasingly permitted in investments, but only until a multiple of the original investment (2 or 3 times, e.g.) has been distributed.]

Redemption: The Series A Preferred will not be redeemable.

[COMMENT: It remains unusual to see a redemption feature in an angel financing.]

Voluntary Conversion: Each holder of Series A Preferred will have the right, at the option of the holder at any time, to convert shares of Series A Preferred into shares of Common Stock at an initial conversion ratio of one to one, subject to adjustment as set forth below.

Automatic Conversion: The Series A Preferred will be automatically converted into Common Stock, at the then applicable conversion rate, in the event of either (i) the election of holders of a [majority] of the then outstanding Series A Preferred, voting together as a class, (ii) the prior conversion of a [majority] of the shares of Series A Preferred, or (iii) the closing of an underwritten initial public offering of the Company's Common Stock pursuant to a registration statement under the Securities Act of 1933, as amended (an "IPO")[, with aggregate proceeds of at least \$_____ million [and a public offering price of at least [_____] times the Series A Purchase Price] [\$_____ per share]] (a "Qualified IPO").

[COMMENT: The automatic conversion feature typically is triggered in three instances: (i) the decision by holders of a specified percentage of the Series A, (ii) the prior conversion of the same specified percentage, or (iii) a specified initial public offering. Many investors do not require the added protection of a Qualified IPO. Any conversion likely will occur only in connection with a liquidity event for the investors (i.e., a sale of the company or an IPO).]

Antidilution Provisions: 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] basis for issuances at a purchase price less than the then-effective conversion price, subject to customary exceptions].

[COMMENT: Price-based anti-dilution protection is often required by angel investors. If included, the extent of the "carve-outs" to the antidilution formula typically will be negotiated, with the Company wanting to retain great flexibility and the investors wanting to preserve the benefit of their economic deal in the face of future issuances below the Purchase Price. Typical carve-outs include: shares issued under Board-approved stock option or similar plans; securities issued in connection with Board-approved acquisitions or strategic transactions; securities issued to financial institutions or lessors in connection with commercial credit arrangements, equipment financings or similar Board-approved transactions; shares issued upon conversion of the Series A Preferred or upon the exercise or conversion of currently outstanding securities; shares issued in the IPO; and shares issued as a result of stock splits, stock dividends or similar transactions.]

VC Investments sometimes feature alternative anti-dilution formulations that are more investor-friendly, such as "full-ratchet" anti-dilution protection in which the conversion price automatically reduces to the lowest price at which securities not covered by the carve-outs are issued. In rare cases, the use of a full-ratchet provision may be appropriate in an angel financing for a period of months or until a specified amount of additional funds is raised (at which point a more standard weighted average anti-dilution provision would kick in.)

Voting Rights: The holders of Series A Preferred will be entitled to vote as a single class with the holders of Common Stock on all matters except as described below or as required by law.

Protective Provisions: For so long as at least ____ shares of Series A Preferred remain outstanding (as adjusted for stock splits, recapitalizations and the like), without the approval of the holders of at least a [majority] of the Series A Preferred then outstanding, the Company will not take any action that (i) alters or changes the rights, preferences or privileges of the Series A Preferred [so as to [materially and] adversely affect such shares], (ii) increases or decreases the [number of authorized shares of Series A Preferred / authorized capital stock of the Company], (iii) creates (by reclassification or otherwise) any new class or series of shares having rights, preferences or privileges senior to [or on a parity with] the Series A Preferred, (iv) authorizes or obligates the Company to pay any dividend or make any other distribution in respect of the Company's capital stock (other than a dividend payable solely in shares of Common Stock), or (v) effects a Corporate Event or other transaction that constitutes a Liquidation.

[COMMENT: There usually will be little negotiation regarding matters that fundamentally affect the rights of the holders (items (i)-(iii)). The remaining items are subject to variations, and additional matters more commonly found in venture capital financings may also be included, such as restrictions on: changing the Company's business; incurring debt over a specified amount; acquiring or investing in other businesses; changing the size of the Board; or increasing the size of the Company's option pool. The Company will be concerned about giving a veto right on significant matters (e.g., change of control transactions, next financings) to minor shareholders.]

Registration Rights: *[COMMENT: Due to the early stage nature of angel investments and the relatively small ownership interest to be held by individual angel investors, they often will be able to freely transfer their shares soon after a Company's IPO even without registration rights. Accordingly, the Company may seek to exclude registration rights.]*

Registrable Securities: All shares of Common Stock issued or issuable upon conversion of the Series A Preferred shall be deemed "Registrable Securities." [In addition, all shares of Common Stock held by the Founders (as defined below) shall be deemed Registrable Securities for purposes of the piggyback registration rights granted hereunder.]

[COMMENT: Consider including the Founders' shares as Registrable Securities for purposes of piggyback registration.]

Demand Registration: No demand registration rights.

[COMMENT: A Company should disfavor a provision such as demand registration rights that forces an IPO, although such rights may be negotiated in angel financings and typically are included in venture financings.]

Piggyback Registration Rights: Subject to customary exceptions, unlimited piggyback registration rights, subject to pro rata cutback (to a minimum of [10%-20%] of the offering (complete cutbacks on a [Qualified] IPO)) of the offering at the underwriter's discretion. The Company and its underwriters shall have the right to terminate or withdraw any registration initiated by the Company.

[COMMENT: "Piggyback" or "incidental" registration rights typically are subject to underwriter's cut-backs in light of perceived market conditions. One hundred percent (100%) cutback is customary for IPOs. Covenants typically provide that in subsequent offerings, cut-backs may be limited, but not less than a stated percentage of the offering. If Founders' shares are considered Registrable Securities, care must be taken to establish whether their rights are subordinate to or on parity with holders of Series A in the face of cutbacks.]

Registration on Form S-3: Subject to customary exceptions, the holders of [at least [10%-50%] of the] Registrable Securities will have the right to require the Company to register on Form S-3, if available for use by the Company, Registrable Securities with an anticipated aggregate offering price of at least [\$500,000 - \$3,000,000]. The Company will not be obligated to effect more than [two] S-3 registration statements in any twelve-month period. [There shall be a limit of a total of [five] such S-3 registrations.]

[COMMENT: There are a few issues to consider in conjunction with any grant of S-3 registration rights. The first is who may invoke the registration. Typically, holders of Registrable Securities may invoke the rights if the offering will exceed a specified dollar amount. A Company will try to limit the number of S-3 registrations it is required to file in any given year (typically 1 or 2) and, perhaps, cap the overall number it must effect (3-5). The Company typically will have certain rights of delay and suspension.]

Registration Expenses: Registration expenses (exclusive of underwriting discounts and commissions, [and fees of counsel to the selling shareholders]) will be borne by the Company for all demand, piggyback and S-3 registrations. [The Company will also pay the reasonable fees and expenses of one special counsel to the selling shareholders not to exceed [\$10,000].]

Transfer of Registration Rights: The registration rights may be transferred to a transferee who acquires at least [____] shares] of the shares originally purchased by a purchaser in this private placement (or all of such transferring holder's shares, if less); provided that the Company is given prompt notice of the transfer and the transferee agrees to be bound by the terms and conditions of the Investors' Rights Agreement. Transfer of registration rights to a partner, member or other affiliate of the transferor will be without restrictions as to minimum shareholdings.

[COMMENT: Transfer of registration rights may be permitted with reference to a stated number of shares. The Company's interest is in making any such threshold or percentage amount high enough to avoid administrative hassles.]

Termination of Registration Rights: The registration obligations of the Company will terminate on the earlier of (i) [five] years after a [Qualified] IPO or (ii) with respect to any holder of registration rights, at such time as all Registrable Securities of such holder may be sold within a three-month period pursuant to Rule 144.

Market Standoff: In connection with a [Qualified] IPO, each holder of registration rights will agree not to sell or otherwise dispose of any securities of the Company (except for those securities being registered, if any) for a period not to exceed 180 days following

the effective date of the registration statement for such [Qualified] IPO if so requested by the underwriters and provided that all directors, officers [and [5]% or greater shareholders] of the Company enter into similar agreements.

[COMMENT: Consider whether the market standoff or "lock-up" should be tied to any public offering, any IPO or just Qualified IPOs. Many investors will not agree to market standoff unless all officers, directors and (1%-10%) shareholders also agree to enter into similar agreements. A Company often will require holders to agree to a 90-day lock-up for subsequent offerings.]

Right of Participation: Each holder of at least [____]% [____ shares] of the Series A Preferred (a "Major Holder") will have the right in the event the Company proposes to offer equity securities (or securities convertible into or exercisable for equity securities) to any person subject to customary exceptions to purchase its pro rata portion (on a [fully-diluted] [outstanding] basis) of such equity securities [plus the portion, if any, that is not purchased by other holders of this right of first offer]. Such equity securities shall be purchased within [15-30] days from notice by the Company on terms no less favorable than those offered or provided by the Company to third-party purchasers of the equity securities. Such right of first offer will terminate immediately prior to the closing of a [Qualified] IPO or a Corporate Event or other transaction that constitutes a Liquidation.

[COMMENT: "Rights of first offer," "pre-emptive rights" or "rights of participation" are less common for angel financings than venture capital financings. A Company will seek to limit any such rights to purchasers of Series A who have made a significant investment. This "Major Holder" concept can be structured as a percentage of the round or on an absolute share basis. Consider whether a right of over-subscription is necessary or appropriate under the circumstances. The carve-outs to the right of participation typically mirror those from the antidilution formula discussed earlier.]

Information Rights: [Beginning after _____,] [T]he Company will deliver to each [Major Holder] [holder of Series A Preferred] (i) [unaudited] 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 no less than 30 days before the end of the preceding fiscal year. Such holders 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 upon a Corporate Event or other transaction that constitutes a Liquidation.

[Employee Options:] [The Company shall implement a stock incentive plan for its directors, officers, employees and consultants. The Stock Incentive Plan shall have _____ shares of Common Stock available for grant as of the Closing.] [Upon the Closing there will be _____ shares of Common Stock reserved for issuance pursuant to outstanding and reserved employee options (including shares previously granted under the Company's current stock incentive plan).]

[COMMENT: In order to avoid dilution to the investors shortly after the close of a financing, the investors may require that an incentive plan be created and/or topped-up concurrently with the financing. Negotiations will focus on who should bear the dilution impact (founders or everyone) and the overall percentage for the Company (on a fully-diluted basis, post-\$) that the incentive pool should represent.]

Board of Directors: Upon the Closing, the Company's Board of Directors will consist of _____ members: (i) [so long as _____ shares of Series A Preferred remain outstanding,] the holders of a [majority] of the Series A Preferred shall be entitled to one member (initially to be _____); and (ii) with the remaining members appointed by holders of a [majority] of

the Common Stock (initially to be _____, _____ and _____).

The Founders and holders of the Series A Preferred shall enter into an agreement to vote their shares and any shares over which they have voting authority to elect the directors designated above.

[COMMENT: Board representation often is not required in angel financings. If included, it is not necessarily proportionate to an investor group's ownership of capital stock. Often a Company will only wish to provide a seat as long as a minimum number of shares of Series A remain outstanding.]

[Non-employee directors will be reimbursed for reasonable travel expenses to Board or other Company-authorized business meetings.]

Other Purchase Agreements: The sale of the Series A Preferred will be made pursuant to a stock purchase agreement reasonably acceptable to the Company and the Investors, which agreement will contain, among other things, appropriate representations and warranties of the Company and the Investors, covenants of the Company reflecting the provisions set forth in this term sheet, and appropriate conditions to closing which will include, among other things, qualification of the shares to be sold under applicable Blue Sky laws, and the filing of an amendment to the Certificate of Incorporation.

Documentation and Expenses: If the financing is consummated, the Company will pay the hourly fees and expenses of special counsel to the Investors, not to exceed [\$5,000], payable at Closing.

[COMMENT: Often not required in angel financings. Reimbursement amounts in venture financings will be higher, in part due to more extensive due diligence review by investors and their counsel.]

SCHEDULE A
POST-FINANCING CAPITALIZATION
(BASED ON INFORMATION BY THE COMPANY)

| <u>Class</u> | <u>Number of Shares</u> | <u>Percent</u> |
|----------------------------|-------------------------|----------------|
| Common Stock | x | % |
| Founders | x | (%) |
| Others | x | (%) |
| Series A Preferred Stock | x | % |
| Warrants | x | % |
| Option Pool: | | |
| Existing Pool ¹ | x | % |
| Outstanding | x | (%) |
| Available | x | (%) |
| [New Pool] | x | % |
| Total | x | 100 % |

¹ Excludes _____ shares previously issued upon exercise of options.

[COMMENT: The "Post-Financing Capitalization" section provides the parties with an early opportunity to understand the existing capital structure and the impact that the financing will have. Pursue an understanding of outstanding convertible instruments (notes, options, warrants) and whether any convertible notes will convert into equity as a result of the round. Consider whether it should be a condition of the financing that the option pool be increased.]