

SUMMARY OF PRINCIPAL TERMS
OF SERIES B PREFERRED STOCK FINANCING OF
XYZ STARTUP, INC.

[Alternative terms are in brackets.]

This memorandum summarizes the principal terms of a proposed Series B Preferred Stock financing of XYZ Startup, Inc. (the "Company"):

Issuer: XYZ Startup, Inc.
University Avenue
Palo Alto, California 94301

Amount of Financing: \$ _____

Security: _____ shares of Series B Preferred Stock

Price: \$ _____ per share ("Original Purchase Price")

Investor: _____ (the "Investor")

Expected Closing Date: _____, 2000

Post-Closing
Capitalization

Series A Preferred
Stock Outstanding: _____ shares

Series B Preferred
Stock Outstanding: _____ shares

Common Stock
Outstanding: _____ shares

Common Stock Reserved
for Options to Employees
and Consultants: _____ shares of Common Stock reserved for options or warrants to employees and consultants, of which _____ were subject to outstanding options as of _____, 2000. The standard vesting schedule for the employee stock option plan is four years, with 25% of option shares vesting upon the first anniversary of service, and the balance vesting on a monthly basis over the remaining three years.

Rights, Preferences,
Privileges and Restrictions
of Series B Preferred Stock.

Generally: The holders of Series B Preferred Stock shall have rights on par with the holders of Series A Preferred Stock. The terms described herein are substantially identical to the terms agreed to in the Company's Series A Preferred Stock financing. The Series A Preferred Stock and the Series B Preferred Stock are sometimes referred to herein as the "Preferred."

Comment: Dividends typically range from 8% to 10% of the Original Purchase Price.

Dividends: The holders of the Series A and Series B Preferred Stock shall be entitled to receive noncumulative dividends at the rate of \$_____ and \$_____, respectively, per share per annum when, as, and if declared by the Board of Directors, prior to any payment of dividends on the Common Stock.

Liquidation Preference: (a) In the event of any liquidation, dissolution or winding up of the Company, the holders of Preferred shall be entitled to receive in preference to the holders of Common Stock the amount of \$_____ per share of Series A Preferred Stock and [original Purchase Price] per share of Series B Preferred Stock. If the funds to be distributed to the holders of Preferred are not sufficient to permit payment in full of the foregoing liquidation preference, then all available funds shall be distributed ratably among the holders of the Preferred in proportion to the preferential amount each holder is otherwise entitled to receive. After payment of such sum, the holders of the Common Stock and the Preferred shall share pro rata in the remaining proceeds (on an as-converted basis). [After payment of such sum, the holders of the Common Stock and the Preferred shall share pro rata in the remaining proceeds (on an as converted basis) until such time as the holders of the Preferred Stock have received a total of three times the liquidation preference per share of Preferred then held (i.e. \$_____ per share of Series A and \$_____ per share of Series B). After payment of such sum, the holders of Common Stock shall receive the remaining proceeds on a pro rata basis.]

Comment: This is a simple participating preferred. A modified version might give the holders of the Common Stock a set amount per share back before all series share ratably on an "as converted" basis.

Comment: Possible to structure so that merger or sale won't be treated as a liquidation if proceeds are in excess of a certain dollar amount.

(b) A consolidation or merger of the Company (where a change of control results) or sale of all or substantially all of its assets shall be deemed to be a liquidation, dissolution or winding up for purposes of the liquidation preference.

Redemption:

Comment: Note that in some cases VCs may seek redemption rights such as these. Note that you will have to consider whether a partial redemption would be a possible deemed dividend treatment for tax purposes.

(iii) Redemption at Option of Investor: At election of the holders of at least 50% of the Preferred, the Company shall redeem 1/3 of the Preferred on the fifth anniversary of Closing, 1/3 on the sixth anniversary of Closing, each at a redemption price equal to the Original Purchase Price [plus a rate of return equal to 10% per year on the Original Purchase Price] minus the amount of any dividends previously paid to holders of Preferred.

Conversion:

Each holder of the Preferred shall have the right to convert its Preferred, at the option of the holder, at any time, into shares of Common Stock of the Company. One share of Preferred shall initially be convertible into one share of Common Stock based on a conversion price equal to the Original Purchase Price ("Conversion Price"). The Conversion Price may be adjusted based on certain events. See "Antidilution Protection" below.

Automatic Conversion:

All outstanding Preferred shall be automatically converted into Common Stock at the then applicable conversion rate, in the event that the holders of at least 2/3 of the Preferred Stock consent to the conversion to Common Stock or _____ upon the closing of an underwritten, registered public offering of shares of the Company at a public offering price per share not less than \$_____ per share and which results in gross proceeds to the Company of at least \$_____ ("Qualifying IPO").

Antidilution Protection

Comment: This "ratchet" is limited until the occurrence of a specific event; i.e., raising additional equity funds at a Closing after the First Closing. This could be structured to apply for a specific period (one or two years instead).

Comment: Narrow-based" antidilution formula does not take account of outstanding warrants and options for purposes of determining adjustment.

Voting Rights:

Comment: If investor has sufficient leverage they might be able to negotiate for control of the Board.

Shareholders' Voting Agreements:

Comment: Provides for investors to obtain control of Board of Directors if Company does not meet its milestones.

Proportional adjustments of the Series A and Series B conversion rates will be made for splits, combinations, stock dividends, recapitalizations, and the like. Also, the conversion rate for the Preferred will be subject to adjustment in the event that the Company issues additional equity securities other than (i) shares (or securities convertible into shares) issued to employees, consultants and directors and (ii) securities issued in connection with credit agreements with equipment lessors or commercial lenders at a purchase price per common stock equivalent to less than the then applicable Conversion Price for each series. The Conversion Price will be subject to ratchet adjustment for any issuances prior to sale of additional equity securities resulting in gross proceeds to the Company of at least \$_____. [Thereafter, the Conversion Prices (and resulting conversion rates) will be subject to adjustment using a broad-based weighted average formula.]

The holder of each share of Preferred shall have the right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of the Preferred Stock. The size of the Company's Board of Directors shall initially be set at _____. The holders of Preferred Stock, voting together as a single class, shall be entitled to elect _____ director(s). The holders of Common Stock, voting together as a single class, shall be entitled to elect _____ directors. The remaining director shall be elected by the holders of Preferred and Common Stock voting together as a single class.

(ix) Shareholders' Voting Agreements: The Investor and _____ and _____ (the "Founders") will enter into a Shareholders' Voting Agreement, whereby each of them will use his or its best efforts to elect one director mutually agreed to by the Investor and the Founders. If the Company does not meet its milestones as approved by the Investor over the next six months the Founders will vote in favor of an increase in the authorized number of directors to _____ and will use their best efforts to elect _____ additional Directors designated by the Investor to fill the vacancies created by such increase.

Protective Provisions:

Comment: This term provides for a "block" on exclusive technology licenses as well as other fundamental matters. Percentage required for approval will depend on composition of current and prior investor groups.

The consent of the holders of a majority of the Preferred Stock shall be required for any action which:

- (i) creates any new class of shares senior to or on parity with the Preferred with respect to dividends or other distributions or liquidation,
- (ii) amends the Company's Articles of Incorporation or Bylaws if such action alters or changes the rights, preferences or privileges of the Preferred,
- (iii) effects any transactions, including any merger of the Company with or into another entity or sale of all or substantially all of the Company's assets which results in a change in voting control of the Company,
- (iv) licenses any of its core technology on an exclusive basis.

Information Rights:

Each purchaser of Preferred and each transferee of a purchaser holding at least _____ shares of Preferred Stock or Common Stock issued upon conversion of the Preferred ("Conversion Stock"), shall be entitled to receive from the Company unaudited monthly and quarterly and audited annual financial statements. These obligations shall terminate upon the closing of the Company's initial public offering of Common Stock.

Registration Rights:

Demand Rights:

If, at any time after the earlier of [two] years from the Closing or six months after the effective date of a registration statement for the Company's initial public offering, holders of Preferred Stock and their transferees request that the Company file a registration statement for their shares, the Company will use its best efforts to cause such shares to be registered. The Company shall not be obligated to effect more than two registrations under this demand right provision.

S-3 Registration:

If available for use by the Company, the Holders will be entitled to S-3 registrations, provided the aggregate offering price of shares sold in such registration is in excess of \$500,000.

Comment: Registrations on Form S-3 not possible until one year after IPO; shorter form, much less expensive.

<p>Company Registration:</p> <p><i>Comment: Limited underwriter "cutback" after IPO; typically 20-30%. Founders may be given limited or subordinate rights.</i></p>	<p>The holders of Preferred and Founders of the Company shall be entitled to "piggyback" registration rights on registrations of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered in view of market conditions; provided, however, that following the Company's initial public offering, the holders and the founders may not be reduced below 25% of a Company registration and all founders must be excluded before any holders are so excluded.</p>
<p>Expenses:</p>	<p>The registration expenses of the aforementioned registrations (exclusive of underwriting discounts and commissions), including reasonable fees and costs of one special counsel for all selling shareholders, shall be borne by the Company.</p>
<p>Transfer of Rights:</p>	<p>The registration rights may be transferred to a transferee who acquires at least _____ shares of Preferred or Conversion Stock. The registration rights shall expire five years from the effective date of the Qualifying IPO.</p>
<p>Other Provisions:</p> <p><i>Comment: Condition "lock-up" on agreement of officers and other employees to be subject to same restrictions.</i></p>	<p>Other provisions shall be contained in the investor rights agreement with respect to registration rights as are reasonable, including the Company's ability to delay the filing of the demand registration for a period of at least 90 days, the agreement by holders of the Preferred Stock if requested by the underwriter in the Company's initial public offering not to sell any Common Stock that they hold for a period of 180 days following the effective date of the registration statement for such offering (subject to officers and directors of the Company entering into similar agreements), cross-indemnification, the period of time in which the registration statement shall be kept effective, underwriting arrangements and the like.</p>
<p>Key Man Insurance:</p> <p><i>Comment: Key man insurance is good source of funds for redemption in early stage company.</i></p>	<p>\$1,000,000 policy on the lives of each of the Founders, with the Company as beneficiary but with proceeds to be applied to redemption of Preferred Stock at the election of holders of the majority of Preferred.</p>

Investor Right of
First Refusal:

Comment: Allows investors to maintain their percentage ownership by participating in subsequent financings.

In the event that the Company issues equity securities or securities convertible or exercisable for equity securities (other than shares (or options to purchase shares) issued to employees, consultants and directors pursuant to approval of the Board of Directors, to equipment lessors or financial institutions and other customary exclusions), each of the holders of Preferred shall be given the right to purchase a percentage of such securities, on the same basis as the other purchasers, equal to the percentage ownership of the Company's outstanding capital stock it holds prior to such issuance. This right shall terminate at the closing of the Company's initial public offering.

Stock Restriction
Agreement:

Comment: No vesting for first year is typical, then monthly.

Each Founder will execute a stock restriction agreement with the Company pursuant to which the Company will have a repurchase option to buy back at cost a portion of the shares of Common Stock held by such person in the event that such shareholder's employment with the Company is terminated, prior to the expiration of 48 months from the date of [employment][the Preferred Stock Purchase Agreement] (the "Measuring Date"). A portion of the shares will be released from the repurchase option based upon continued employment by the Company as follows: 25% will be released from the repurchase option on the first anniversary of the Measuring Date and an additional 2.08% will be released on the completion of each month thereafter. The Company and then the Investor will also have right of first refusal with respect to any Founder's shares proposed to be resold, which right will terminate upon a public offering.

Investor Co-Sale Rights:

Comment: Co-sale rights are almost never actually used but may be important where an individual is key to investment and you can't impose vesting.

The holders of Preferred will also have co-sale rights on a pro rata basis (based upon their relative holdings of the Company's capital stock on a fully-diluted basis) with respect to transfers of the founder's shares of the Company's capital stock. This right will terminate at the closing of the Company's Qualifying IPO.

Drag-Along Rights:

Holders of a majority of Preferred and Common will have the right to require other holders of Preferred Common who are parties to the Rights Agreement to vote to approve certain corporate transactions including mergers.

<p>Board Observation Rights:</p> <p><i>Comment: If Investor does not hold a Board seat.</i></p>	<p>The Company shall execute a management rights letter with Investor pursuant to which an Investor representative shall have the right to attend all meetings of the Board of Directors in a non-voting advisory capacity and the right to examine Company records. Such rights will terminate upon the closing of the Company's IPO.</p>
<p>Qualified Small Business Stock:</p>	<p>The Company represents and warrants to the Investors that it qualifies as a "Qualified Small Business" as defined in Section 1202(d) of the Internal Revenue Code of 1986, as amended (the "Code") and covenants that so long as the Shares are held by the Investors (or a transferee in whose hands the Shares are eligible to qualify as Qualified Small Business Stock as defined in Section 1202(c) of the Code), it will use its best efforts to cause the Shares to qualify as Qualified Small Stock.</p>
<p>IPO Allocation:</p> <p><i>Comment: More appropriate for later stage financing.</i></p>	<p>In the event of an initial public offering for the capital stock of the Company (the "IPO"), the Company shall request that the managing underwriters of the IPO establish a directed share program (the "Program") in connection with the IPO. The Program shall consist of at least that number of shares of capital stock determined by dividing \$_____ by the IPO price (the "Minimum Shares"). The Company shall cause the managing underwriters to give priority to them with respect to the Minimum Shares in allocating the shares available for purchase in the directed share program.</p>
<p>Proprietary Information and Inventions Agreement:</p>	<p>Each officer, director and key employee of the Company will enter into a proprietary information and inventions agreement with the Company.</p>
<p>The Purchase Agreement:</p>	<p>The purchases of the Preferred will be made pursuant to a preferred stock purchase agreement reasonably acceptable to the Company and the Investor, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein and appropriate conditions to closing which will include, among other things, qualification of the shares under applicable Blue Sky laws, the filing of Amended and Restated Articles of Incorporation, receipt of an opinion of counsel and a minimum investment of \$_____.</p>
<p>Expenses:</p>	<p>The Company and the Investor will each bear their own legal and other expenses with respect to the transaction (except that, assuming a successful completion of the transaction, the Company will pay reasonable legal fees and expenses incurred by counsel to the Investor).</p>

Counsel to the _____:[name of firm]
[address]
Telephone:
Fax:
Attention:

This memorandum of terms does not constitute an offer and is presented solely for discussion purposes.
This memorandum of terms shall not be construed as creating any obligation on any party whatsoever.