Gust Series Seed Term Sheet

This term sheet for financing early stage companies with investments from sophisticated angel investors was developed by Gust, the platform powering over 90% of the organized angel investment groups in the United States. The goal was to standardize on a single investment structure, eliminate confusion and significantly reduce the costs of negotiating, documenting and closing an early stage seed investment.

For those familiar with early stage angel transactions, this middle-of-the-road approach is founder-friendly and investor-rational, intended to strike a balance between the Series A Model Documents developed by the National Venture Capital Association that have traditionally been used by most American angel groups (which include a 17 page term sheet and 120 pages of supporting documentation covering many low-probability edge cases), and the one page Series Seed 2.0 Term Sheet developed in 2010 by Ted Wang of Fenwick & West as a contribution to the early stage community (which deferred most investor protections and deal specifics until future financing rounds.)

TERMS FOR PRIVATE PLACEMENT OF SEED SERIES PREFERRED STOCK OF [*Insert Company Name*], INC.

[Date]

The following is a summary of the principal terms with respect to the proposed Seed Series Preferred Stock financing of ___________, Inc., a [Delaware] corporation (the "***Company***"). Except for the sections entitled "Expenses", "No Shop/Confidentiality" [and "Special Terms"], such summary of terms does not constitute a legally binding obligation. Any other legally binding obligation will only be made pursuant to definitive agreements to be negotiated and executed by the parties.

Shares of stock are only applicable to an incorporated company (which means that this term sheet is only applicable to a C Corporation. Angel investments in a Limited Liability Company are more complex, and require a different structure.) Delaware is the favored state of incorporation for US businesses (including more than half of the Fortune 500) because it is considered "corporate-friendly" with well-established case law. While not required either by law or by this term sheet, incorporation of the company in Delaware is strongly advised. Recently, Nevada has developed a similar reputation, and is sometimes used as the incorporation venue for companies based on the West Coast.

This term sheet is, for the most part, "non binding", which means that it is used only to document the general meeting of the minds between the two parties, and not to serve as the legal basis for the investment. However, this paragraph makes clear that the three specific sections referenced, "Expenses", "No Shop/Confidentiality" and "Special Terms" (if such a section is included), ARE legally binding, and once this term sheet is signed by both parties, those sections [only] are immediately in force. Therefore, regardless of whether or not the investment is ultimately made, any breach of things such as the confidentiality provisions, or the requirement to pay legal fees, can subject the breaching party to legal action by the other.

Note that the company name should be inserted in both the title and in this paragraph, the state of incorporation should be inserted where indicated, and the brackets should be removed. If there is a Special Terms section added to the document, the brackets around that phrase should be removed, otherwise delete the whole bracketed phrase.

Offering Terms

Securities to Issue: Shares of Seed Series Preferred Stock of the Company (the "***Series Seed***").

In exchange for their financial investment, the investors under this term sheet are acquiring shares of stock in the company. Unlike Common Stock (which is what is usually purchased on the public stock markets), this term sheet specifies Preferred Stock. The difference is that in the case of a sale, liquidation or winding up of the company, the Preferred Stock gets paid back first, before any Common Stock (which is typically what Founders and employees of the company hold.) However, because Preferred Stock gets back ONLY the amount invested, all of the upside goes to the Common Stock holders. For that reason, a subsequent section of this term sheet provides for the option of the investors to convert the Preferred to Common, if such conversion would be in the investors' interest.

Note that the class of stock being purchased in this investment round is named "Series Seed". This is a purely arbitrary name, for reference purposes. Traditionally, a first, relatively small, investment round from angel investors or a seed fund would be called a Series Seed. The first institutional investment round from a venture capital fund would be called a "Series A", with each subsequent round incrementing one letter (Series B, Series C, etc.)

Aggregate Proceeds: Minimum of $_______ [and maximum of $_________ in aggregate].

This sets forth how much money the company is planning to raise in this round. Investors typically would not want to fund their commitments until they are sure that the company will receive enough money to be able to achieve its objectives for this round. As such, even if the investors and the company sign the term sheet today, no money will change hands until at least the minimum amount is committed by adding additional commitments from other investors. If the company and investors have agreed upon a maximum amount to be raised, insert it here and remove the brackets. If there is no maximum, delete the bracketed phrase.

Lead Investors: __________________ who will invest a minimum of $_________

This sets for the identity of the investor(s) who are signing this term sheet and committing to invest in the company. While other investors may participate in the funding, the primary investor (whether individual, fund or group) may (but need not) be granted additional rights in the term sheet. The amount here is the minimum amount that the Lead investor(s) are committing to this round, and is distinct from the minimum amount required to consummate the investment.

Price Per Share: $ _______ (the "***Original Issue Price***"), based on a pre-money valuation of $____, calculated based upon the capitalization of the Company as set forth in Exhibit A inclusive of an available post-closing option pool of 15% after receipt of maximum Aggregate Proceeds.

The price that investors will pay for each share of Preferred Stock is calculated on the basis of the other factors noted in the term sheet, as well as the number of shares that the company has authorized (or will do so as part of this round). This price is usually filled in last, with the important number in this paragraph being the "pre-money valuation". This is the amount that the Founders and investors agree that the company is worth as of the date the term sheet is signed, before the investors' money is received by the company.

To make this section absolutely clear for everyone, it refers to Exhibit A to the Term Sheet, which is a Capitalization Table for the company, showing in names and numbers exactly who owns what shares, both before and after the investment.

In the second part of the sentence the parties agree that before the investment happens, the company will set aside extra shares of Common Stock that will be used to attract and compensate future employees. This is known as the "unallocated, post-closing, option pool". The important thing to understand here is that the 15% for the option pool is what will exist AFTER the investment, but the calculation is done BEFORE the investment is made. That means all of the shares for the option pool come out of the Founder's shares, not the investors'.

Here is an example: A founder owns 100% of a company. Investors put in $350,000 in exchange for 35% ownership. That means the "post money" valuation of the company is $1 million, and the "pre-money" valuation (after subtracting out the $350,000) is $650,000. However, as the term sheet indicates, there needs to be a pool of 15% of the stock available for employee options. This means the post-closing Cap Table shown in Exhibit A will show 35% for the investors, 15% for the option pool, and 50% for the Founder.

Dividends:

Annual 5% accruing cumulative dividend payable when as and if declared, and upon (a) a Redemption or (b) a Liquidation (including a Deemed Liquidation Event) of the Company in which the holders of Series Seed receive less than 5 times the Original Issue Price per share (the "Cap"). For any other dividends or distributions, participation with Common Stock on an as-converted basis.

> A dividend on Preferred Stock is roughly equivalent to interest on a loan. This paragraph says that investors are entitled to a 5% dividend each year on their investment, but that the company's Board decides "when, as and if" dividend payments are actually made. Since growing companies always need cash, it would be extremely unusual for a Board to declare a dividend payment during the early years. However, "accruing cumulative dividends" means that if the dividends are not paid each year, they continue to accrue until such time as they are.
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> This paragraph sets out a couple of additional cases where the accrued dividends must be paid: (a) is the highly unusual case in which after seven years (as laid out in a subsequent section) the company is successful but the investors have not been able to get their money out, and therefore require the company to repurchase their stock; and (b) a sale or other winding up of the company…but only in a case where the investors would otherwise receive less than a 5X return.
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> Finally, the last sentence says that if the Common Stock (usually held by the Founders) gets a dividend, so does the Preferred Stock held by the investors.

Liquidation Preference:

One times the Original Issue Price plus any accrued and unpaid dividends thereon (subject to the "Cap") plus any other declared but unpaid dividends on each share of Series Seed, balance of proceeds paid to Common. A merger, consolidation, reorganization, sale or exclusive license of all or substantially all of the assets or similar transaction in one or a series of related transactions will be treated as a liquidation (a "Deemed Liquidation Event").

> This paragraph says that if the company is converted to cash ("liquidated") whether for happy reasons, such as getting acquired for a billion dollars, or sad ones, such as going out of business and selling the furniture, after paying all of its debts (which always get paid before equity) any remaining money first goes to pay back the amount put in by the investors and then goes to pay the accrued dividends. After that, everything and anything that's left goes to the Common Stockholders (typically the Founders and employees.)
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> While this sounds good for investors in the sad case, it means that in the happy case, even if the company is sold for a billion dollars, the only money the investors will get back is their original investment plus the 5% dividend. That's the reason for the next section: conversion.

Conversion:

Convertible into one share of Common (subject to proportional adjustments for stock splits, stock dividends and the like, and Broad-based Weighted Average anti-dilution protection) at any time at the option of the holder.

> Here's where investors get their return: while Preferred Stock gets paid off first, it doesn't participate in any upside benefits. On the other hand, Common Stock gets a proportional share of any incoming money (such as a from the proceeds of an acquisition), but have to stand in line behind the Preferred. So this paragraph says that investors who hold Preferred Stock can choose at any time to convert it into Common Stock. The result is that in a bad scenario (the company is going out of business) the investors stay with Preferred, and get the first money out. But in a good scenario (an acquisition at a high price), they will choose instead to convert to Common, and share in the good things.
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> The "Broad-based Weighted Average anti-dilution protection" means that if the company at some point in the future raises money at a lower valuation than that being used for the current round, the current investors will be partially protected. This provision is a middle-of-the-road industry standard, halfway between the Founder-biased "no anti-dilution" approach and the Investor-biased "full ratchet anti-dilution" version.

Voting Rights: Votes together with the Common Stock on all matters on an as-converted basis. Approval of a majority of the Series Seed required to (i) adversely change rights of the Series Seed; (ii) change the authorized number of shares; (iii) authorize a new series of Preferred Stock having rights senior to or on parity with the Series Seed; (iv) create or authorize the creation of any debt security if the Company's aggregate indebtedness would exceed 50% of the aggregate proceeds of the Series Seed; (v) redeem or repurchase any shares (other than pursuant to the Company's right of repurchase at original cost); (vi) declare or pay any dividend; (vii) increase in the option pool reserve within two years following the closing; (viii) change the number of directors; or (ix) liquidate or dissolve, including any change of control or Deemed Liquidation Event.

> This is where most of the protective provisions for investors are found. It says that even though investors hold Preferred Stock, when it comes to voting we will treat them as if they had converted to Common Stock, so that everyone who owns stock (founders, investors, et al) gets to vote together on things requiring Shareholder approval. However, in addition to their voting alongside every other shareholder, this paragraph provides for a "series vote" on certain issues. That is, even if the Board of Directors and 100% of all the other shareholders voted to do something in one of these areas, it wouldn't happen unless a majority of the investors in this round agreed. The subjects requiring a series vote are generally ones that protect the investors from having their rights stripped, or their voting power diluted out of existence, or having the money they just put in go to someone else.

Documentation: Documents will be based on Seed Series Preferred Stock documents published at http:/gust.com/SeriesSeed which will be generated/drafted by Company counsel.

> A term sheet lays out the general outline of an investment, but the devil is in the details. Once the Term Sheet is signed and the company and investors proceed to a closing, the lawyers then draft dozens of pages of documentation, including an amended Certificate of Incorporation, a Shareholders' Agreement, an Investors' Rights Agreement, etc. The Gust website has a set of standard, model documents that match the provisions of this term sheet, and make it very easy for an attorney to use them as the basis for his or her work.
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> While nothing will be signed and finalized until both the parties and their respective attorneys are satisfied, someone has to take the first step in drafting the documents. This paragraph says that the Company's counsel will do so, based on the Gust standard docs.

Financial Information: All Investors will receive annual financial statements and narrative update reports from management. Investors who have invested at least $25,000 ("***Major Investors***") will receive quarterly financial and narrative update reports from management and inspection rights. Management rights letter will be provided to any Investor that requires such a letter. All communications with Investors shall be conducted through Company's secure investor relations deal room on the Gust platform, which Company shall be responsible for maintaining with current, complete and accurate information.

> Because private companies are not required to file any statements with the Securities and Exchange Commission, this section lays out what information the company will be required to provide to its investors so that they are aware of what is happening with their investments. It provides for annual financial and written update reports from the company's management be sent to all investors. In addition, investors who have put in more than $25,000 are entitled to quarterly reports, and also have the right to visit the company on request and see the corporate books and records (subject, of course to confidentiality.)
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> A Management rights letter is a particular document required by certain venture funds.
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> To ensure timely communications with investors, the company is required to keep its information updated and current in its Gust deal room, which will greatly enhance both the company's investor relations, and the investors' portfolio management activities.

Participation Right: Major Investors will have the right to participate on a pro rata basis in subsequent issuances of equity securities.

> If the company sells additional stock at any time in the future, this says that each investor has the right (but not the obligation) to participate in such future rounds on the same terms as the new investors, at least up to an amount that will enable them to maintain the same percentage ownership after the new investment that they had before.

Redemption Right: The Series Seed shall be redeemable from funds legally available for distribution at the option of the holders of a majority of the outstanding Series Seed commencing any time after the seventh anniversary of the Closing at a price equal to the Original Purchase Price plus all accrued but unpaid dividends and any other declared and unpaid dividends thereon. Redemption shall occur in three equal annual portions.

> If, after many years, the company ends up as 'lifestyle' business, where it is profitable but not likely to ever have an exit, this paragraph gives the investors the right to require the company to buy back their stock for what they paid for it (plus dividends.) The repurchase (known as "redemption") would take place over three years, starting at the investor's option any time after the seventh year.

Board of Directors: Two directors elected by holders of a majority of Common stock, one elected by holders of a majority of Series Seed. Series Seed Director approval required for (i) incurring indebtedness **[exceeding $25,000]** for borrowed money prior to the Company being cash flow positive, (ii) selling, transferring, licensing, pledging or encumbering technology or intellectual property, other than licenses granted in the ordinary course of business, (iii) entering into any material transaction with any founder, officer, director or key employee of the Company or any affiliate or family member of any of the foregoing, (iv) hiring, firing or materially changing the compensation of founders or executive officers, (v) changing the principal business of the Company or (vi) entering into any Deemed Liquidation Event that would result in the holders of Series Seed Series receiving less than 5 times their Original Purchase Price.

> The Board of Directors of a company is in charge of making all major decisions, including hiring/firing the CEO. This paragraph establishes a three-person board, with two of the members appointed by the Common stockholders, and one by the investors in this round.
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> While this 2:1 ratio means that the directors appointed by the Common (usually the founder(s) themselves) could always outvote the investor, the term sheet equalizes things by setting forth a number of areas in which not only does a majority of the board have to approve, but the director appointed by the investors must also specifically approve. The $25,000 limit on borrowing is rational for smaller deals, but can be increased for larger ones.

Expenses: Company to reimburse Investors a flat fee of $______ for background check expenses, due diligence and review of transaction documentation by Investors' counsel. Company shall be responsible for expenses related to Company's Gust investor relations deal room.

> Out of pocket expenses related to closing an investment are typically picked up by the company out of the investment proceeds. Given no deviation from this standard term sheet, a moderate flat fee for all of the investors' legal work is eminently reasonable, likely much less than the $20,000 or more when a full-scale NVCA term sheet is used. Including the cost of maintaining the company's investor relations site means that investors are assured of always getting up-to-date information in a form that is immediately usable to them.

Future Rights: The Series Seed will be given the same contractual rights (such as registration rights, information rights, rights of first refusal and tag along rights) as the first series of Preferred Stock sold to investors on terms similar to, or consistent with, NVCA or other standard documents customary for venture capital investments by institutional investors.

> This is the magic paragraph that ensures investors are protected with all the provisions included in the NVCA Model Documents, assuming that the company does a follow-on investment round with an institutional investor such as a traditional venture fund. It is what allows us to cut 14 pages worth of detail out of this term sheet, compared to the NVCA one.

Founder Matters: Each founder shall have four years vesting beginning as of the Closing, with 25% vesting on the first anniversary of the Closing and the remainder vesting monthly over the following 36 months. Full acceleration upon "Double Trigger." Each Founder shall have assigned all relevant IP to the Company prior to closing and shall have entered into a non-disclosure, non-competition and non-solicitation agreement (to the fullest extent permitted by applicable law), with such non-competition and non-solicitation covenants to be applicable during the term of his or her employment by the Company and for one year after the termination thereof. Founders shall be subject to an agreement with the Company pursuant to which the Company shall have a right of first refusal with respect to any proposed transfer of capital stock of the Company at the price offered.

> This section provides for what is called "reverse vesting" for the company's founders. Even though they may start out owning 100% of the company's stock, this gives the company the right to repurchase the stock owned by the Founder(s) if they leave the company. The terms are the standard 'four year vesting/one year cliff', which means that if the founder leaves within the first year after the investment, the company can re-acquire all of his or her stock, and after the one-year anniversary, the remaining stock vests monthly over the next three years. While some Founders initially find this onerous, it is actually *very* much in each of the Founders' best interest, because otherwise one co-founder (say, out of two) could theoretically walk away from the company the day after the closing, and retain nearly half of the equity…something that would be manifestly unfair to the other founder.
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> The "full acceleration upon Double Trigger" means that if the company is acquired before the four years are up, and the new owners terminate the Founder, all of the remaining stock owned by the Founder immediately vests.
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> Other provisions of this section including ensuring that the Founder(s) have fully assigned all of their intellectual property so that it is owned by the company, that they have entered into an employment agreement providing for non-disclosure of confidential information, and that if they leave the company they are restricted for a year from either directly competing with the company, or poaching its employees.
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> Finally, this section says that if Founders want to sell any of their stock, they are required to first offer it to the company.

No Shop / Confidentiality: The Company and the founders agree that they will not, for a period of 60 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 and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. The Company and the founders will not disclose the terms of this Term Sheet to any person other than officers, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to the Investors, without the written consent of the Investors.

> The idea behind a No Shop provision is that investors do not want to be used as a 'straw man' for the purpose of helping the company get a better deal from someone else. So there can be as much discussion as necessary, and as many un-signed drafts of the term sheet exchanged as necessary, but the minute the company signs this term sheet, they are agreeing that for 60 days they won't talk to anyone else about investing, without the investors' approval.

Special Terms: [Deal specific comments/conditions inserted here. Otherwise "None".]

> In order to keep the rest of the term sheet absolutely standard and reduce legal and drafting costs, there should be absolutely NO modifications within the text of the other sections of the term sheet. This "Special Terms" section is the one place that anything unusual or specific to this particular investment should go, although the more special terms or modifications there are, the longer it will take to negotiate, and the more the legal fees will cost. Remember that every page in the Term Sheet ultimately translates into ten or more pages of the actual deal documentation, and every new or special provision added requires that the lawyers on both sides write, read and negotiate something non-standard. As a rule of thumb, every time the documents need to go back and forth between the lawyers, it adds approximately $5,000 to the overall legal costs for the transaction.

COMPANY: [__________, INC.]	FOR THE INVESTORS:
______________________________	______________________________
Name: ______________________	Name: ______________________
Title: ______________________	Title: ______________________
Date: ______________________	Date: ______________________

> Since parts of the Term Sheet are legally binding, it should be signed by someone legally able to bind both parties. This would normally be the CEO of the company, and a Lead Investor who is firmly committed to investing in the company on these terms.

This sample term sheet was developed by Gust with the legal support of Lori Smith, Esq. of White and Williams, and extensive comments from the members of the New York Angels Term Sheet Committee including Larry Richenstein, Jeffrey Seltzer and Mark Schneider. *Annotations and commentary copyright © 2013 by David S. Rose.*