

VENTURE CAPITAL TERM SHEETS

**Grant W. Collingsworth
Morris, Manning & Martin, L.L.P.
3343 Peachtree Road, N.E.
Atlanta, Georgia 30326
(404) 504-7786**

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**VENTURE CAPITAL INVESTMENT
TERM SHEET
(with commentary)**

Company:	Generic Software, Inc. (the "Company")
Amount of Investment:	\$2,000,000
Form of Investment:	2,000,000 shares of Series A Convertible Preferred Stock, \$.01 par value (the "Preferred A"). VCs almost always invest in preferred stock.
Use of Proceeds:	Software development, patent development and general working capital purposes. The VCs want to make sure that their money is used to grow the Company.
Stock Option Plan:	10% of the fully diluted shares outstanding post-financing will be reserved for issuance to employees and consultants according to a stock option plan. VCs know that motivated employees are the key to a Company's success.
Rights, Preferences, Privileges and Restrictions of Preferred:	<p>(1) <i>Dividend Provisions:</i> Dividends will be cumulative and accrue at a 10% annual rate and be payable in-kind, upon liquidation, redemption, merger, consolidation, or conversion of Preferred A. VCs usually want a minimum fixed return without burdening the Company with periodic payments, and they like the option of getting it in cash or stock.</p> <p>(2) <i>Liquidation Preference:</i> In the event of liquidation, sale, merger, consolidation or winding up of the Company, the holders of Preferred A will be entitled to receive in preference to holders of Common an amount equal to the purchase price of the shares plus all accrued and unpaid dividends. If the Company liquidates, the VCs want their money first. You probably don't care unless the preference includes a sale of the Company.</p> <p>(3) <i>Conversion Price:</i> The total number of shares of Common into which Preferred A may be converted will be determined by multiplying the number of shares of Preferred A to be so converted by the purchase price and dividing the result by the conversion price. The conversion price initially shall be equal to the purchase</p>

price but will be subject to adjustment as provided in paragraph (5) below. **The VCs have the right to convert into common stock at anytime, but they never will unless the Company is sold or goes public.**

(4) *Automatic Conversion*: Upon the closing of an Initial Public Offering of shares of the Common at a public offering price that is not less than 5 times the per share price of the Preferred, with net proceeds to the Company of at least \$10 million, the Preferred A holders will automatically convert into common at the then applicable conversion price. **If the Company goes public, even the VCs know that their preferential rights go away, but they want to know that it's a "real IPO."**

(5) *Antidilution Provisions*: If the Company issues additional shares at a purchase price less than the applicable conversion price of Preferred A, the conversion price used to determine the number of shares of Common into which shares of Preferred A may be converted will be reduced on a weighted average formula basis. **If the Company sells cheap stock (i.e. below the price of the preferred stock), the VCs have been diluted and they want more stock. The key issue here is "weighted average" versus "full ratchet."**

(6) *Voting Rights*: Except with respect to election of directors and certain protective provisions or as required by law, the Preferred A will vote together with the Common with the right to that number of votes equal to the number of shares of common issuable upon conversion of the Preferred A. **The VCs will probably have a minority position, but the protective provisions give them the real power.**

(7) *Protective Provisions*: For so long as at least 25% of the Preferred A remain unconverted, consent of the holders of at least a majority of the Preferred A will be required for: (i) any sale by the Company of all or substantially all of its assets, (ii) any merger of the Company with another entity, (iii) any liquidation or winding up of the Company; (iv) any amendment of the Company's charter in a manner adverse to this class of stock, (v) the issuance of any equity or debt security

senior to or on parity with the Preferred, or (vi) the payment of any dividend on or the purchase, redemption or other acquisition of any security junior to the Preferred A. **Some of these rights are provided by law, the remainder by negotiating leverage.**

(8) *Redemption*: Holders of at least a majority of the Preferred A may elect to cause the Company to redeem the Preferred A in two equal annual installments commencing on the fifth anniversary of the issuance of the Preferred A at a redemption price equal to the greater of the fair market value or purchase price plus all accrued and unpaid dividends. Upon default in the payment of any required redemption installment, the unpaid balance shall accrue interest at the rate of 15% per annum, payable quarterly in arrears. Default in the payment of any required redemption installment which continues for more than ninety days after notice shall be a voting right event permitting the Preferred A to elect a majority of the Board of Directors during the continuance of such default. **The VCs won't invest unless they have an exit strategy. If the Company doesn't have the money to redeem the Preferred A after five years (which is likely), the VCs will use this provision to take over the Board and force a sale of the Company. The concept is usually not negotiable, but the term and/or payout schedule may have some flexibility.**

Board of Directors:

The Company's Board of Directors shall be comprised of two representatives of the Common Shareholders, of which one shall be the CEO; two nominees of Battery, and one mutually agreed upon industry representative who shall not otherwise be affiliated with the company. The Company will reimburse all non-employee directors for their reasonable expenses to attend Board meetings. **The VCs are your new business partners and they will want Board representation. The VC representatives may be in the minority, but beware of "veto" rights (usually relating to compensation or related party transactions).**

Information Rights:

So long as any of the Preferred are outstanding, the Company will deliver to each investor audited annual and unaudited quarterly and monthly financial statements, annual budgets and other information

reasonably requested by any investor owning shares of Preferred, provided that such investor is not employed by or associated with a competitor of the Company.

The VC is already on the Board, so he'll have access to everything anyway.

Registration Rights:

(1) *Demand Rights*: The holders of a majority of the Preferred (voting together) may request that the Company file a registration statement under the Securities Act of 1933, as amended, covering the shares of Common requested to be registered, and the Company will use its best efforts to cause such shares to be so registered. The company will not be obligated to effect and consummate more than two demand registrations (other than on Form S-3 or any equivalent successor form) under this provision. A registration will not count for this purpose unless it is closed or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company). The Company shall not be required to effect any registration within one hundred eighty days of the effective date of any other registration statement on Form S-1. **If the Company goes public, the VC will want to sell its stock as soon as possible. Registration is at the Company's expense, and it isn't cheap, so the game is to limit the number of demand registrations.**

(2) *Piggy-Back Registration*: The Investors will be entitled to unlimited "piggy-back" registration rights on registrations of the Company, subject to customary underwriter's cutback. **Not as important an issue for the Company, but make sure that the VC can't keep the founders from participating in the IPO.**

(3) *Registration Expenses*: The Registration expenses (exclusive of underwriting discounts and commissions but including the fees of one counsel for the selling shareholders) of each of the registrations under paragraphs (1), (2) and (3) above will be borne by the Company. **VCs never want to spend their money, even after the Company goes public.**

First Refusal Right for Purchase of New Securities:

Until the initial public offering of the Company, or until fewer than 25% of the Preferred remains outstanding, if the Company proposes to offer any

shares for the purpose of financing its business (other than shares issued to employees in the form of stock options, shares issued in the acquisition of another company, or shares offered to the public pursuant to an underwritten public offering), the Company will first offer all such shares to the Investors. **If the Company needs a second round of financing, the VC wants first shot at the deal.**

Stock Restriction Agreement:

The Founders and the Company's key employees will each execute a Stock Restriction Agreement with the Investors and the Company pursuant to which the Company first and the Investors second, will have a right of refusal with respect to any shares proposed to be sold by such persons. The Stock Restriction Agreement will contain a right of co-sale in favor of the Investors providing that before any such person may sell any of his Common shares, 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 Investors. **If the founders want to sell, the VC wants the option of either buying the stock or selling stock along with them.**

Noncompetition, Nonsolicitation and Nondisclosure Agreement:

Following the closing, the Company will cause each Founder and key employee to enter into a two year noncompetition, nonsolicitation and nondisclosure agreement, all such agreements to be in a form reasonably acceptable to the Investors. **VCs usually take this opportunity to make sure the Company is protecting itself the way it should.**

The Purchase Agreement:

The purchase of the Preferred A will be made pursuant to a Series A convertible Preferred Stock Purchase Agreement drafted by counsel to the Investors. Such agreement shall contain, among other things, appropriate representations and warranties of the Company and the Founders; covenants of the Company reflecting the provisions set forth herein and other typical covenants; and appropriate conditions of closing. **The key points for negotiation are usually the representations and warranties and indemnification for breaches of the representations and warranties.**

Expenses:

The Company will pay the Investors' expenses for legal fees. **VCs usually get their legal fees paid by the Company, but insist on one counsel for all VCs and a cap on fees.**

Conditions to Closing:

The proposed transaction is subject to satisfactory completion of due diligence by the Investors. **It's not over til it's over.**