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LAWYERS, PATENT & TRADE-MARK AGENTS
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FINANCING PRECEDENTS

Term Sheet

A PUBLICATION OF THE SCOTT & AYLEN
VENTURE CAPITAL/CORPORATE FINANCE
GROUP

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VENTURE CAPITAL PRECEDENT

TERM SHEET

IMPORTANT NOTES:

Entrepreneurs often seek outside investors to finance the growth of their company. An important source of such financing are institutional investors who specialize in providing capital to emerging businesses in high growth markets. The negotiations surrounding the entering into, conduct during, and conclusion of such a relationship can be complicated. A Term Sheet serves as a basic framework for the investment as it maps out the foundational issues of the deal. The attached annotated Term Sheet is fairly detailed and therefore requires the parties to reach consensus on a number of critical items at the outset of their investment relationship.

DISCLAIMER

This document is intended for internal use as a GUIDE and to provide general educational information only. It is NOT a definitive agreement. All provisions in this document should be thoroughly reviewed to ensure that they accurately reflect the particulars of a given transaction. This document is not a substitute for legal advice and should only be used after consulting with a lawyer.



**INVESTMENT CAPITAL CORPORATION
(INVESTMENT CO.)**

**Term Sheet in respect to proposed investment in
TARGET CO.
, 1999**

Except as expressly provided herein, this term sheet does not constitute a binding agreement and represents an expression of intent of the terms to be contained in definitive agreements. Any investment by the Investors will be in all respects contingent upon and subject to, among other things, satisfactory completion of due diligence and negotiation of satisfactory documentation.

<i>Preamble</i>	<i>It is important to note that a term sheet, subject to the notable exceptions of several clauses (such as those relating to exclusivity, non-disclosure, access to information and expenses) is an agreement in principle and not a binding contract between the parties.</i>
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Investee Target Co. (the ACompany@)

Investors Investment Co. and mutually agreed upon co-investors (collectively the AInvestors@)

<i>Investors</i>	<i>Often Investors prefer to syndicate as a means to minimize their total financial risk through investing in a portfolio of different companies. It is therefore quite common to have a number of institutional investors involved in the transaction.</i>
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Amount A total financing of up to \$5,000,000 CDN (the AInvestment Amount@) to be provided approximately as follows:

Investment Co.:	\$ 3,000,000.00
Co-investors:	\$ 1,500,000.00
Existing Investors:	\$ 500,000.00

A minimum of \$4,000,000 will be required to complete the financing.



Amount

An additional means used by Investors to hedge against financial risk is to stage the financing into tranches. Customarily, the tranches subsequent to the initial financing amount are not binding obligations on the Investor unless the Investee meets specific performance/technical targets or milestones. Staged financing is often a preferable alternative for the Investee as well. Suppose, for example, that an Investee projects that it will require \$5,000,000 of equity financing. The Investor decides to invest the \$5,000,000 in two tranches. Typically, the second round of shares will be sold at a higher price per share than the first round: if, hypothetically the first round was sold at \$1/share and the second round at \$3/share, the result is that the Investee only sells 3,333,333 shares to raise \$5,000,000, rather than the 5,000,000 shares it would have had to have sold at the first round price to receive the same amount of capital.

Use of Funds

To fund working capital requirements.

Use of Funds

This term sheet clause normally becomes a covenant in the subscription agreement among the parties. It is intended to confirm management representations as to the use of funds and to prevent the illicit or improper use of the investment funds. The use of funds by an Investee is dependent on the nature of its business, and the variations of the clause are therefore numerous. Beyond funding capital requirements, it is common that the investment proceeds are used for the following types of activities: research and development; direct sales expansion; operations and manufacturing programs; capital expenditures; and administrative expenses, to name a few. The simplest broad expression of the covenant is for Target Co. to covenant to use the funds for working capital purposes. An alternative is to use funds in accordance with the Company's Annual Business Plan. An Investor finds comfort in this statement by virtue of the fact that it will have a nominee director as a condition of their investment (see below) and thus has a measure of control over the substantive content of the Annual Business Plan.

Security

A new class of preferred share (A Class A Pref. Shares®) ranking in preference to all other classes of equity and having the terms described herein.



Security

An equity investment into convertible preferred stock is almost always the most desirable form of securities from both the Investee's and Investor's perspectives. From the latter point of view, convertible preferred stock provides both the dividend payment in priority to any dividends payable to common shareholders and a liquidation preference; consequently providing both a first call on the remaining assets of the business should Target Co. prove to be unsuccessful, as well as the ability to receive dividends if the contra proves to be the case.

From the former's point of view, convertible preferred stock, on the assumption that dividends will not in the near future be paid out, increases the non-debt capitalization of the firm. In addition, the Investee's stock is still an attractive equity incentive tool as the preference provisions have only minor consequences on the share value should the Target Co. become successful, and therefore allows the Target Co. as employer to attract and retain talented employees.

Investors also prefer to receive preferred securities because until converted such securities normally have attached to them special rights protecting their interests, such as anti-dilution protection. In rare cases, an Investor may perceive an investment as particularly risky and wish to obtain greater security than convertible preferred equity can provide. One means to achieve this is for Target Co. to issue a convertible secured debt instrument in favour of the Investor. This form of security benefits the Investor through payment of interest, places the Investor as a secured creditor before all other equity holders in the event of the insolvency of Target Co., and provides for the conversion of the debt instrument into equity securities in Target Co. at the Investor's option.

Exclusivity

The Company, upon signing and returning this term sheet to Investment Co., agrees that for a period of 45 days subsequent thereto that Investment Co. (and the co-investors identified herein) will have the exclusive right to negotiate and complete the investment transaction contemplated herein.

Exclusivity

*This type of clause is also commonly referred to as a *lock-up*, and provides the Investors with a period of time in which they enjoy the right, but not the obligation, to complete the investment. Such a clause allows an Investor a window of opportunity during which it can perform its due diligence on Target Co. without the concern that Target Co. may be contemporaneously negotiating a similar deal with a similar Investor.*



Class A Pref. Shares

Issue Price: \$ # per share

Aggregate Number: # Class A Pref. Shares

Aggregate Amount: \$ #

Voting Rights: Entitled to one vote per share at a meeting of holders of Class A Pref. Shares, and a right to vote on an as-if-converted basis for all other matters in conjunction with the holders of common shares.

<i>Voting Rights</i>	<p><i>Each share of preferred stock is usually entitled to that number of votes equal to the number of shares of common stock into which the preferred stock converts. Notwithstanding this general as-if-converted rule, voting rights with respect to the Board and protective rights are often the subject of further negotiation.</i></p> <p>1. <i>Board Voting Rights</i> <i>It is quite common that an Investor will insist upon the series of stock into which they are investing being entitled to nominate a director. Another provision that can be used by an institutional Investor to protect their involvement is a voting shift provision pursuant to which the preferred shareholders may elect either additional directors or a majority of the board, in the event that the Company fails to meet certain milestones.</i></p> <p>2. <i>Protective Rights</i> <i>An Investor will also seek a separate class vote (normally on a majority basis) with respect to particular material corporate events: for example, mergers; the borrowing of money; or changing the share capital structure. Target Co. should resist this type of provision as it fetters its ability to manage the Company's affairs.</i></p>
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Dividend: Each Class A Pref. Share participates equally on the declaration of dividends on an as-if-converted basis.

<i>Dividend</i>	<p><i>Most investments are into start-up and/or early stage companies which will not be in a position to pay dividends to the holders of preferred stock. Dividends can be structured so that they are either mandatory or non-mandatory, cumulative or non-cumulative. Commonly, where dividends cumulate, Target Co. will try to negotiate that upon automatic conversion (ie. an IPO or other</i></p>
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triggering liquidity event) of the preferred shares, the Investor's right to previously accrued but unpaid dividends will be waived by the Investor.

Price Protection:

If the Company issues common shares (or securities convertible into common shares) other than shares issued pursuant to any stock option plan or shares issued to employees in connection with their employment, prior to conversion of Class A Pref. Shares into common shares, at a price per share lower than the Issue Price, then the number of common shares issued to the Investors on conversion will be adjusted, from time to time, such that the average cost per common share is equal to the price per share of the most recent issue.

Price Protection

As a minimum, an Investor will insist upon weighted average anti-dilution protection to reduce dilution of their position if Target Co. issues additional stock at a price lower than that paid by the Investor. This form of protection operates by adjusting the conversion price at which the preferred stock can be converted into common stock to reflect the fact that the recent issue of stock was at a price and therefore valuation of the Company less than the valuation represented by the Investor's investment. The weighted average aspect provides that the adjustment only applies to the Investor's shares on a pro rata basis measured against the number of shares issued at the lower price.

More severe than a weighted average protection mechanism is a full ratchet anti-dilution clause which provides that any issuance of securities at a price lower than the price paid initially by the Investors results in an adjustment of all shares held by the Investor.

Target Co. will normally attempt to negotiate an exemption from anti-dilution protection of the shares or options that are issued to officers and key employees. Another Investee tactic is to provide continuing anti-dilutive protection only to those Investors who participate in subsequent financing rounds. This form of clause is often referred to as Pay to play. Pay to play provisions usually manifest themselves in one of three ways:

- 1. A forced conversion of non-participating Investors into common stock;*
- 2. A forced conversion of the preferred shares into a parallel series of preferred shares with no price-based anti-dilution; or*
- 3. A contractual waiver by a non-participating shareholder of such adjustments*

Conversion of Class A Pref.

Shares:

Conversion is one-to-one, subject to price protection and standard anti-dilution



provisions for stock dividends and share splits.

Convertible at any time, in whole or in part, at the option of the Investor. Mandatory conversion on (i) a qualifying round of financing, being a financing by the Company with proceeds of at least \$7.5 million CDN and at a pre-money Company valuation of at least \$40 million CDN; or (ii) a qualifying initial public offering, being an underwritten IPO in Canada or the United States (but which includes prospectus filing or reporting issuer status in Ontario) with gross proceeds to the Company of at least \$25 million CDN and a listing of common shares on the TSE, NASDAQ National Market or other acceptable exchange.

Liquidation Preference: Senior to all other equity securities. In the event of liquidation holders of Class A Pref. Shares will be entitled to receive greater of (i) 2 times per share price paid, together with any declared but unpaid dividends, or (ii) pro rata portion of the proceeds calculated on an as-if-converted basis and in priority to the holders of common shares.

Liquidation Preference

A simple preference provides priority for the original purchase price. Where the security is convertible the preference should always be the greater of the original price and the pro rata share if converted. The clause above provides a double-dip by providing for double the original purchase price as a minimum preference.

Subscription Agreement

A share purchase agreement between the Investors and the Company will be executed. It will include, but not be limited to, the following provisions:

1. The Company covenants and warrants that at closing the Company is in good legal standing, has valid title to its assets including any Intellectual Property, has no material legal actions outstanding and is not infringing any patents;
2. There has been no material adverse change in the business or financial condition of the Company since # , 199# and prior to closing;
3. The Company to covenant that at closing the Company's products are Millennium Compliant® and the Company's operations will be Millennium Compliant® prior to December 31, 1999;

Other terms and conditions standard to such agreements including normal



representations and warranties by Investors and the Company, to be agreed upon by both parties.

Subscription Agreement

The securities in a financing are almost always sold pursuant to a subscription agreement which sets out the representations, warranties, and covenants of all parties to the transaction. Perhaps the most important document relating to the subscription agreement is the Company counsel opinion letter which supports the legal representations made by the Company concerning: its capital structure; the adherence to and/or applicability of securities laws with respect to the transaction; and the proper corporate approvals of the transaction.

The Company will normally be required to make representations concerning: its legal standing; its valid title to all intellectual property; that full disclosure of all material information has been made; the accuracy of the Company's financial statements; and the absence of litigation or infringement by the Company among other things.

The Company will also require the Investors to make certain representations concerning: their qualification to purchase the securities; that the Investors have received the required corporate approvals of the investment; and an acknowledgement that the Investors had access to the Company information and has had the opportunity to ask all questions required to reach an informed decision with respect to the transaction.

Shareholders= Agreement

Investors and major existing shareholders will become party to a shareholders= agreement, in form satisfactory to the Investors, including the following provisions:

1. Restrictions on issue and sale of shares, including pre-emptive right to maintain share ownership level, right of first refusal on resales, piggy-back, drag along.
2. Board composition established at 5 directors, with Investors entitled to nominate one representative and one observer. Requirement for at least 3 directors, inclusive of Investors nominee, to be independent of management.
3. Restrictions on transactions with, and payments, distributions and remuneration to management and non-arm's length parties.



4. Board approval of any employee stock option, share purchase or incentive plan.
5. Quarterly financial reporting and information and access rights for Investors.
6. Appropriate key-person life and other applicable business risk insurance in amount and on terms satisfactory to Investors. Covenant to obtain directors and officers insurance if available on acceptable terms as determined by the board of directors of Company after closing.
7. Permitted transfer provisions to affiliates, subject to execution by affiliate of counterpart to shareholders agreement.
8. Investors shall receive the following registration rights: Unlimited Company paid participation/secondary rights on IPO and subsequent offerings, subject to underwriter cut-back and regulatory escrow requirement, if any. Investors preference in secondary on IPO and subsequent offerings for up to the greater of (a) 50% of such secondary offering; or (b) such number of shares then representing \$3,500,000 CDN.

Pre-emptive Right

Investors will usually attempt to maintain their equity interest in the Company by negotiating a right to purchase securities offered by the Company in the future. This right entitles the Investor to receive notice of the offering, and to purchase its pro rata share of the offered securities under the same terms offered to any third party Investor. Additionally, the right may also entitle the Investor to purchase securities not purchased by other Investors. Typically, the right does not apply to issuances such as employee incentive compensation or issuances made to the Company's commercial lenders in the ordinary course of business. This particular right should not be contentious, provided that the investment terms are the same as those offered to other Investors.

Right of First Refusal

A standard provision involves the right of Investors to purchase a founder's share at the same price that a founder is prepared to sell to a third party. The provision usually requires that a bona fide third party offer has been reserved so as to avoid manipulative arrangements and requires that the offer be a cash offer so as to provide certainty as to price.



Co-sale/Piggy Back Rights

Co-sale rights provide an Investor with the means to achieve liquidity and are an attempt to prevent the founder from abandoning the Company before the Investors. Under a right of co-sale or piggy-back, founders and other significant shareholders give the Investors the right to participate pro rata in any sale of their shares to a third party. The number of shares that a shareholder subject to the co-sale obligation can sell is reduced and replaced by the number of shares that the Investors elect to sell to the third party.

Repurchase Rights

Repurchase rights entitle either the Company to Acall the stock@for repurchase, or the Investor to Aput@the stock to the Company and may be in addition to, or contained within redemption or retraction rights contained in the articles of the Company as part of its constating documents. Repurchase at the Company's option is rare and is usually limited to very attractive companies. More typically, Investors will insist that the Company repurchase their stock, at the Investor's election and under certain conditions. In this event, the parties must agree on:

- 1. The repurchase price. The repurchase price usually consists of: (i) the original purchase price; (ii) accrued and unpaid dividends; and (iii) repurchase premium. The Investors may want to limit the repurchase premium in order to avoid a Aconstructive dividend@tax being assessed on the premium.*
- 2. Mandatory vs. Optional Investor Redemption. Mandatory redemption typically is not attractive to either the Company or to Investors. For Investors, mandatory redemption discourages new Investors from participating in future financings given the risk that working capital will be used to redeem earlier Investors. For the Company, the redemption makes it difficult for the Company to obtain bank loans and trade credit. In short, optional redemption provides both parties with greater flexibility to address future capital needs.*

*Registration Rights*Over and above the rights afforded in the revised articles and the subscription agreement, Investors will usually seek additional rights through an Investor Rights Agreement. There may be some overlap between the rights negotiated into the articles and the Investor Rights Agreement, and it is not uncommon for the latter to include:

- 1. AInformation Rights@, notwithstanding that the Investors will have a seat on the board. Each Investor will also require financial information, reports and other disclosure from the Company.*



2. *The Investors may want to be in a position to compel the Company to become a reporting issuer in Canada through a prospectus offering or, in the United States context, to publicly register its stock through a public offering and include the Investor's stock in the registration. These concepts have a variety of alternatives:*
 - a. *Demand Registration Rights entitle the Investor to demand that the Company complete an IPO and/or register its stock within a specific period of time after the investment round. In the US context the Investor will want to be able to force registrations periodically in order to market efficiently the resale of the Investors holding. It is usual that management can resist the demand if, in its discretion, business conditions are not favourable to such action. It is usual that all expenses incurred in demand registrations are paid by the Company.*
 - b. *Secondary Participation/Piggy Back registration rights obligate the Company to include the Investor's stock in any public offerings or registration the Company intends to make. It should be noted that the Investor's right is always subject to the underwriter's right not to include the Investor's stock in the offering - and the right in the US context is usually carved-out with respect to the offering of securities in the context of a corporate acquisition or employee stock benefit plan.*

Information and Access

Company will co-operate fully with Investors and their counsel, and provide unrestricted access to all property, books, documents, records and officers, employees and consultants. Investors will treat information not otherwise in the public domain or obtained by Investor from third parties not subject to a confidentiality obligation in favour of the Company as confidential and use same only for the purpose of evaluating the financing.

Non-Disclosure

Company will not disclose the existence or content of this term sheet, or the state of negotiations among Investors and Company, to any person other than advisors and Company personnel having a need-to-know and subject to a similar obligation of confidentiality. Upon closing, the fact of the transaction may be publicly disclosed, provided such disclosure is reviewed and approval by Investors prior to release.



- Conditions Precedent**
1. Approval of each Investors= respective investment committees, as appropriate and required;
 2. Satisfactory completion of due diligence;
 3. Documentation in form and substance satisfactory to the Investors and the Company, inclusive of corporate opinion.
 4. Approval by the Company-s board of directors.

Target Closing Date The transaction to close on or about # , 1999 but in any event not later than #, 1999.

Expenses Investors= legal, due diligence and transaction expenses associated with the proposed transaction, including travel and due diligence investigations, are for the account of the Company and are payable whether or not the transaction is completed. Investors= transaction expenses and Investors= legal expenses not to exceed \$20,000 without prior approval of the Company.

Absence of Enforceable Agreement Except for the terms relating to Exclusivity, Information and Access, Non-Disclosure and Expenses, this term sheet is not an enforceable agreement, but merely a letter of intent subject to the negotiation and execution of definitive agreements.

Acceptance This letter is open for acceptance and delivery to Investment Co. until # , #, 199# at 5:00 p.m.

Per:
Investment Co.

Accepted and agreed to this _____ day of _____, 199#.

Target Co.

Per:
Authorized Officer