

Securities for the Business Attorney

Issues Influencing Finance Structure and Investment Decisions: A Case Study

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Issues Influencing Finance Structure and Investment Decisions **(A Case Study)**

❖ **Background Facts:**

- Startup company planning to develop proprietary software able to more seamlessly translate web browser pages into handheld mobile browser pages
- Tom Trendsetter, Founder
 - Serial entrepreneur (3d startup)
 - Previously CEO of a public company
 - Currently planning to self-fund initial research & development but interested in discussing and considering options for raising capital

❖ **General Phases of Company Funding:**

- A. Establish the Company – Entity formation and initial funding
- B. Build and Fund the Prototype – Appropriate types and sources of funding
- C. Beta and Staffing Up – How much money to raise and how to raise it
- D. Build Product and Launch – Compensate and incentivize management and employees

A. **ESTABLISH THE COMPANY**

1. **Entity Formation**

a. **Corporate Form**

- i. **C Corporation**
- ii. **S Corporation**
- iii. **Limited Liability Company**

b. **Tax considerations**

- i. **Pass through losses depending on entity choice**
- ii. **Tax issues for investors**

❖ **Business Considerations:**

- Attorney not just a scrivener; part of management/advisory team
- Business decisions have legal implications now & later
- Overall consideration of how to build a business base and get funded

❖ **Legal Considerations:**

- Similar corporate protection for corporation or limited liability company

- Less corporate formality with an LLC
- Investor friendly entity structure may require conversion of entity later
- Liquidity/Illiquidity issues

2. Initial Funding

a. Debt v. Equity

i. Pros & Cons of Debt Financing

1. Advantages to Small Business/Founder(s)

- a. Simple (usually, but banks can be more difficult)
- b. Nondilutive

2. Disadvantages to Small Business/Founder(s)

- a. Debt service (cash flow is extremely important and usually very tight)
- b. Limitations on leverage
 - i. Lenders will consider debt ratios for future lending
 - ii. Too much debt may hurt ability to raise equity later
 - iii. Personal Guaranty likely required from founder(s) by a bank

3. Advantages to Lender

- a. Senior position to equity holders in a dissolution
- b. Debt repayment with interest is a source of revenue

4. Disadvantages to Lender

- a. Unsecured debt is risky; additional steps necessary to secure debt
- b. Participation in company's growth is limited to debt repayment
- c. Intellectual property as collateral can be of little value to a bank

ii. Pros & Cons of Equity Financing

1. Advantages to Small Business/Founder(s)

- a. Investors bear risk of loss of investment
- b. Immediate capital infusion
- c. Theoretically unlimited ability to raise money by selling equity interests
- d. No debt service

2. Disadvantages to Small Business/Founder(s)

- a. Stock sales can be complex and expensive business transactions (costs \$ to raise \$)

- b. Highly regulated by state and federal laws**
- c. Dilutive event for existing stockholders**

3. Advantages to Investor

- a. Higher risk may yield higher return on investment than debt**
- b. Participation in company's financial success**

4. Disadvantages to Investor

- a. Junior position to creditors in a dissolution**
- b. Illiquid investment – need a liquidation event to “cash out” and realize value (ex. merger, acquisition, IPO, liquidation)**

b. Self funding v. outside funding (friends & family)

i. Sources of Debt Financing

- 1. Traditional Private Lenders – banks, credit unions, credit cards**
- 2. Traditional Public Lenders – government loan programs (SBA)**
- 3. Other Private Lenders – “angel” investors, friends & family**

ii. Sources of Equity Financing

- 1. Personal savings**
- 2. Friends & family**

iii. Advantages of friends & family

- 1. Personally and professionally supportive**
- 2. Tends to be easy, informal process**
- 3. Flexible terms and conditions**

iv. Disadvantages of friends & family

- 1. Typically not sophisticated investors; be sure they understand the investment risk**
- 2. Bad deal can affect personal relationships**
- 3. Informality can mean problems later (expectations, documents, disclosure)**

❖ Business Considerations:

- Needs to be “fund-worthy”
- How “bankable” is/are the founder(s); personal guaranty likely required for loans
- Business plan should address financing issues
- Like a chess match; attorney helps analyze steps now to end up with fewer mistakes later
- Consider use of Nondisclosure Agreement under appropriate circumstances

❖ Legal Considerations:

- Applicability of the securities laws
 - Triggered by the purchase or sale of a “security,” the definition of which is very broad
 - Generally, a securities transaction occurs if a person invests in an enterprise and expects profits from the managerial efforts of others or if a person provides the risk capital for an enterprise and expects profits without receiving the right to exercise practical and actual control over managerial decisions
- Determining Whether an Investment Constitutes a Security May be Difficult
 - Stocks and bonds are traditional forms of “securities”
 - Other types of investments may be securities depending facts
 - The typical bank loan with a promissory note will generally not trigger the securities laws
 - Convertible promissory notes from the company to investors are securities
- Section 4(2) exemption for “transactions by an issuer not involving any public offering”
- Minnesota Statutes Chapter 80A sets forth applicable state statutes regarding registration of securities

B. BUILD AND FUND THE PROTOTYPE

1. Funding from “Sophisticated” Sources

- a. **Type of Investor(s) depends on stage of company’s development**
 - i. **“Angel” Investors**
 - ii. **Small/Local Fund Networks**

❖ Business Considerations:

- Networks can be difficult to find and even more difficult to access
- Lawyer can be very helpful in finding “Angels”
- Angels often invest in the \$100-\$1MM range (can be higher or lower)
- Networking Groups List handout is a good starting point

❖ Legal Considerations:

- Recommend dealing only with “accredited” investors
- Need to determine applicable exemption
- Need appropriate disclosures for types of investors
- Be careful of the types of rights granted to investors at this point; could create issues later
 - Board seat
 - Antidilution
 - Preferred stock rights

2. Advantages of “Angel” Investors

- i. Typically sophisticated investors**
- ii. Tend to be less active than other “professional” investors in management matters**
- iii. Flexible terms and conditions**
- iv. Industry contacts can be especially helpful in later rounds**

b. Disadvantages of “Angel” Investors

- i. Can be difficult to find/meet (need connections, interest in your space)**
- ii. Unregulated party (ex., terms of deal can be aggressive)**
- iii. Security for repayment of company debt may be required**
 - 1. Personal guarantee**
 - 2. Pledge of shares**

❖ Business Considerations:

- Valuation issues typically arise at this point
- Debt has certain advantages over equity at this point
- Company may consider a private placement/offering of stock
- Later investors may consider earlier rounds in determining valuation
- Diligence issues may cause investors to seek to mitigate risk by valuing company at a discount

❖ Legal Considerations:

- Selling common stock is a securities issuance (even to friends & family)
- Legal counsel should be involved throughout the offering and sale process
 - assist in preparation of private placement memorandum and/or other disclosure documents
 - be involved in planning before offering, during sale and after; involvement only after can be too late
 - Pay attention to state(s) in which investors live (state blue sky law issues)
- Legal documents need to be accurate and complete so that later investors doing due diligence don't find problems

C. BETA AND STAFFING UP

1. Funding from “Professional” Sources

- a. At this stage of company's development, likely raising larger dollar amounts from deeper pockets**
 - i. Venture Capital**
 - ii. Institutional investors**
 - iii. Strategic partners**
- b. This is probably the valuation that will “matter”**
 - i. Early valuations may have been too high/too low (usually too high)**

ii. Depending on how earlier investments were valued and structured, existing shareholders could get “squeezed” down

❖ Business Considerations:

- Company’s goal at this point is to capture users and monetize their product
- Lawyer can be very helpful to company in evaluating which potential investment is the best deal – NOT based solely on dollar amount proposed to be invested
- Lawyer should be engaged to assist in negotiating terms; potentially very complex documents with broad implications for the company and other shareholders

❖ Legal Considerations:

- Get involved at the beginning of the process; client discussion should include
 - how much the client is going to offer/sell
 - ◆ existing capital structure
 - ◆ rights of first refusal
 - ◆ enough authorized capital stock
 - when and what the client last sold
 - ◆ same security or not
 - ◆ how long between offerings
 - where the client intends to sell
 - ◆ blue sky law requirements unique to each state
 - ◆ securities legends in ppm
 - how the client intends to go about offering/selling
 - ◆ finders
 - ◆ broker/dealer
 - to whom the client will be offering/selling
 - ◆ accredited investors
 - ◆ non-accredited investors
- Need to determine applicable exemption
- Need to establish basis for exemption
 - Subscription Agreement reps and warranties
- Need appropriate disclosures for types of investors
 - ◆ accredited investors
 - ◆ non-accredited investors
- Need thorough and accurate documentation of the transaction
- Company will need to go through an investment due diligence process with one or more potential investors for each round of financing
- Help the client understand ways to avoid a general solicitation (ex. No talking to the press)

2. Most private equity investments will look to Regulation D as the securities exemption although there are a variety of other exemptions that may be available depending on the specific nature of the transaction in question

- a. Absent an exemption from registration, every securities transaction that uses the U.S. mails or other means of interstate commerce must be registered with the Securities and Exchange Commission (the “SEC”).
 - b. Section 4(2) of the Securities Act of 1933, as amended (the “Act”) exempts from the registration requirements of Section 5 all “transactions by an issuer not involving any public offering.”
 - c. The interpretation of Section 4(2) by the SEC and the courts was not always crystal clear, so in 1982 Regulation D was adopted by the SEC as a regulatory safe harbor.
 - d. Offerings that are in compliance with the requirements of Regulation D will not be considered public offerings and will not, therefore, require registration.
 - e. Regulation D was “designed to simplify and clarify existing exemptions, to expand their availability, and to achieve uniformity between federal and state exemptions in order to facilitate capital formation consistent with the protection of investors.” *Securities Act Release No. 33-6389 (March 8, 1982)*.
 - f. Regulation D applies only to issuers, individuals may not use Regulation D.
3. In order to obtain the safe harbor of Regulation D, offerings must comply with one of three exemptions:
- a. **Rule 504**: Offers and sales not exceeding an aggregate offering price of \$1,000,000 during any 12-month period
 - b. **Rule 505**: Offers and sales to an unlimited number of accredited investors and a maximum of 35 non-accredited investors where the offering price does not exceed \$5,000,000 during any 12-month period
 - c. **Rule 506**: Offers and sales to an unlimited number of accredited investors and up to 35 non-accredited investors, who must be sophisticated investors, without regard to the dollar amount
 - i. Securities issued under 506 are “federal covered securities” therefore state registration and qualification requirements are preempted by Section 18(b)(3) of the Act
 - ii. If issuer loses 506 exemption can potentially fall back on 4(2), not so with others
 - iii. “Sophisticated” investor means that the purchaser or purchaser’s advisor must have such knowledge and experience in financial matters that he or she is capable of evaluating the merits and risks of the particular investment
4. When disclosure is required in a Regulation D offering varies depending on which rule the securities are being sold under and the status of the purchasers
- a. A written disclosure document is required when securities are sold under Rules 505 or 506 to anyone that is not an accredited investor

D. BUILD PRODUCT AND LAUNCH

- 1. Company will want to compensate and incentivize management and employees**
 - a. Stock Options**
 - i. Options are securities**
 - ii. Document options properly**
 - 1. Option plan (as applicable)**
 - 2. Stock Option Agreements for each optionee**
 - b. Rule 701 -- Exemption for Offers and Sales of Securities Pursuant to Certain Compensatory Benefit Plans and Contracts Relating to Compensation**
 - i. Issuers eligible to use this section of the '33 Act (federal exemption) if not a reporting company**
 - ii. Pay attention to requirements relating to state exemptions as well**
 - 1. Rule 701 is not an exemption from applicable state securities laws**
 - 2. Minnesota Statutes Section 80A.46 sets forth applicable state transactional exemptions**

❖ Business Considerations:

- Size of option pool likely a negotiated point with venture capital/institutional investors
 - Make sure investors are in alignment with size of option pool
- Management will need to determine terms of options and get necessary approvals
- Options give management and employees participation in potential success/upside of business
 - Use to judiciously compensate management, employees and board
- Goals at this stage
 - develop and build the company
 - hit the market aggressively
 - build management team

❖ Legal Considerations:

- Must pay attention to satisfying requirements of Rule 701
- State exemption requirements may impose an additional burden, make sure to check applicable blue sky laws
- Need to make sure the company/management is very diligent about documenting options grant process
 - Number and grant date of Options
 - Vesting Schedule
 - Strike Price
 - Document approval of grant
 - Signed documents

ATTACHMENTS

Attachment 1 – Private Investment Transaction Document Checklist

Attachment 2 – Form of Convertible Promissory Note Term Sheet

Attachment 3 – Form of Convertible Promissory Note

Attachment 4 – Recent Selected Private Equity Financing Related Articles

Attachment 5 – Networking Groups List (Handout)

ATTACHMENT 1

PRIVATE INVESTMENT TRANSACTION DOCUMENTATION CHECKLIST

Company Approval

- _____ 1. Share issuance authorized and approved by the Board of Directors
- _____ 2. Board approval documented by resolutions or written action
- _____ 3. Written action signed by all Board members
- _____ 4. Resolutions or written action added to corporate minute book

Corporate Capitalization and Structure

- _____ 1. Confirmed the company has enough shares authorized and available for issuance (include issued but unexercised options, warrants and conversion of preferred shares)
- _____ 2. Filed amended Articles of Incorporation to increase the number of shares if not enough
- _____ 3. Amended Articles of Incorporation added to corporate minute book
- _____ 4. If subchapter S corporation, confirmed issuance will not invalidate S election (e.g., new class of shares, inappropriate investor)
- _____ 5. Capitalization table has been updated to reflect issuance(s)

Corporate and Shareholder Issues

- _____ 1. Considered existing company rights (right of first refusal, call rights, other rights)
- _____ 2. Considered existing shareholder rights (antidilution, right of first refusal, co-sale rights, preemptive rights, put rights, other rights)
- _____ 3. Applicable shareholder rights have been complied with or waived in writing and company has copies
- _____ 4. Applicable company rights have been complied with or waived in writing and company Has copies
- _____ 5. Confirmed transfer was made in accordance with applicable corporate documents (e.g., bylaws, original share purchase agreement, etc.)
- _____ 6. Obtained signed copy of the assignment/stock power from transferor
- _____ 7. Cancelled transferor's original share certificate
- _____ 8. If original share certificate lost, obtained affidavit of loss and indemnity agreement from transferor
- _____ 9. Cancelled share certificate stamped "cancelled" and placed in share book
- _____ 10. Share ledger updated to reflect cancelled certificate and newly issued shares

Disclosure and Securities Compliance

- _____ 1. Obtained complete list of all investors and their respective states of residence
- _____ 2. Checked federal securities law for an exemption (issuer v. non-issuer transaction)
- _____ 3. Checked relevant state blue sky laws for an applicable exemption or federal preemption
- _____ 4. Prepared and distributed appropriate disclosure documents
- _____ 5. Required federal and state securities filings have been made and copies retained in corporate files
- _____ 6. Calendared all annual filings, if any

Transaction Documents

- _____ 1. Confirmed company has received adequate consideration for issuance
- _____ 2. Fully executed transaction documents have been obtained
- _____ 3. Form of share certificate has been approved by the Board
- _____ 4. Appropriate legends have been placed on share certificates (e.g., '33 Act legend, right of first refusal, repurchase right, shareholder agreement, etc.)
- _____ 5. Share certificates have been appropriately numbered, dated and signed
- _____ 6. If shares held in escrow, obtained signed escrow agreement and appropriate escrow procedures in place
- _____ 7. All share issuances have been entered into share records
- _____ 8. Shareholder list has been updated with current shareholder contact information and added to share records

ATTACHMENT 2

FORM OF CONVERTIBLE PROMISSORY NOTE TERM SHEET

ATTACHMENT 3

FORM OF CONVERTIBLE PROMISSORY NOTE

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, AS AMENDED (THE “ACT”). THEY MAY NOT BE SOLD, OFFERED FOR SALE, PLEDGED OR HYPOTHECATED IN THE ABSENCE OF A REGISTRATION STATEMENT IN EFFECT WITH RESPECT TO THE SECURITIES UNDER THE ACT OR AN OPINION OF COUNSEL SATISFACTORY TO THE COMPANY THAT SUCH REGISTRATION IS NOT REQUIRED OR UNLESS SOLD PURSUANT TO RULE 144 OF THE ACT.

[Note: A promissory note is normally a “security” for purposes of federal and state securities laws. A company will typically rely on either Section 4(2) or Regulation D of the '33 Act.]

**[BORROWER]
SECURED CONVERTIBLE PROMISSORY NOTE**

[\$[AMOUNT BORROWED]

[CITY, STATE OF BORROWER]

[DATE]

[BORROWER], a [BORROWER’S STATE OF INCORPORATION] corporation (the “*Company*”), the principal office of which is located at [BORROWER’S ADDRESS], for value received hereby promises to pay to [LENDER], a [LENDER’S STATE OF INCORPORATION] corporation (the “*Lender*”), or its registered assigns, the sum of [AMOUNT BORROWED WRITTEN OUT] Dollars (\$[AMOUNT BORROWED]). The principal and any unpaid accrued interest, as set forth below, shall be due and payable on [DUE DATE OF NOTE] (the “*Maturity Date*”). Upon the written request of the Company, the holder of this Note (the “*Holder*”) may elect, in its sole discretion, to extend the Maturity Date until [EXTENDED MATURITY DATE] on the terms and conditions set forth in this Note.

The following is a statement of the rights of the Holder and the conditions to which this Note is subject, and to which the Holder hereof, by the acceptance of this Note, agrees:

1. Interest; Prepayment

1.1 Interest. The Company shall pay interest at a rate equal to the lesser of: (i) [INTEREST RATE WRITTEN OUT] ([INTEREST RATE]%) per annum, or (ii) the highest rate allowable under law, on the outstanding principal amount of this Note (the “*Initial Interest Rate*”).

1.2 Prepayment. The Company shall have the right, exercisable at any time by written notice to the Holder at least 30 days prior to the exercise of such right, to pay all, but not less than all, of the principal amount of this Note and accrued interest prior to the Maturity Date, without penalty.

2. Conversion

2.1 Optional Conversion. The Holder has the right, at the Holder’s option, at any time before payment in full of all amounts of principal and interest payable under this Note or the conversion of all such amounts pursuant to this Section 2.1 or Section 2.2, to convert this

Note, in whole or in part, into fully-paid and non-assessable shares of Series X Preferred Stock of the Company (the “**Optional Conversion Stock**”) at the rate of \$[PRICE PER SHARE] per share of Series X Preferred Stock (the “**Conversion Price**”), subject to adjustment, if any, of the Conversion Price and the securities or other property issuable upon conversion as may be required by Section 3.

2.2 Automatic Conversion.

(a) To the extent not previously converted, the outstanding principal amount owing under this Note and all accrued and unpaid interest under this Note shall automatically convert into shares of Series Y Preferred Stock of the Company (or such other series of Preferred Stock of the Company as is issued in the Qualifying Financing described below) (the “**Automatic Conversion Stock;**” together with the Optional Conversion Stock, the “**Conversion Stock**”) upon the closing of a round of equity financing which meets the following criteria (the “**Qualifying Financing**”): (i) net receipts to the Company of at least [MINIMUM NET RECEIPTS TO BORROWER SPELLED OUT] Million Dollars (\$[MINIMUM NET RECEIPTS TO BORROWER]); (ii) a pre-money valuation of the Company of not more than [MAXIMUM PRE-MONEY VALUATION OF BORROWER SPELLED OUT] Dollars (\$[MAXIMUM PRE-MONEY VALUATION OF BORROWER]); (iii) a lead investor that is a third-party, first-tier institutional investor approved by the Holder in its reasonable discretion; and (iv) the financing occurs prior to a Corporate Transaction (as defined below). The number of shares of Automatic Conversion Stock into which this Note will be converted pursuant to this Section 2.2(a) shall be determined by dividing the aggregate principal amount of this Note, together with all accrued interest to the date of conversion, by the per-share purchase price of the Automatic Conversion Stock in the Qualifying Financing.

[Note: The criteria for conversion (items (i), (ii) and (iii) above) can be adjusted to suit an investor’s requirements and the Company’s needs.]

(b) If the Qualifying Financing does not close prior to the Maturity Date but the Company has received and delivered to the Holder prior to the Maturity Date a signed commitment from investors to invest in a round of equity financing that meets the criteria of a Qualifying Financing, then the Maturity Date will be delayed until the earlier to occur of (x) the closing of the Qualifying Financing and (y) the day two months following the Maturity Date.

2.3 Conversion Procedure. Before the Holder shall be entitled to receive certificates representing shares of Conversion Stock under Section 2.1 or Section 2.2, it shall surrender this Note and the Notice of Conversion attached hereto at the principal office of the Company. Such conversion shall be deemed to have been made immediately prior to the close of business on the date of the closing of the Qualifying Financing, and the person or persons entitled to receive the shares of Conversion Stock issuable upon such conversion shall be treated for all purposes as the record holder or holders of such shares of Conversion Stock as of such date.

2.4 Delivery of Stock Certificates. As promptly as practicable after the conversion of this Note, the Company at its expense will issue and deliver to the Holder a certificate or certificates for the number of full shares of Conversion Stock issuable upon such conversion.

2.5 No Fractional Shares. No fractional shares of stock shall be issued upon conversion of this Note. In lieu of the Company issuing any fractional shares to the Holder upon the conversion of this Note, the Company shall pay to the Holder the amount of outstanding principal or interest that is not so converted, such payment to be in the form of check or cash. Upon conversion of this Note in full, the Company shall be forever released from all its obligations and liabilities under this Note, except that the Company shall be obligated to pay the Holder as provided in this Section 2.5.

3. Adjustments and Combinations

3.1 No Amendment of Terms of Series X Preferred Stock. The Company covenants not to amend the terms of the Series X Preferred Stock as set forth in the Amended and Restated Certificate of Incorporation of the Company as of the date of this Note, including without limitation any amendment to change the antidilution protection granted in Article IV Section 3 or to effect a subdivision or combination of the Series X Preferred Stock.

[Note: This is an investor-friendly restriction on the Company.]

3.2 Reclassification, Exchange and Substitution. If the Series X Preferred Stock issuable on conversion of this Note shall be changed into or exchanged for the same or a different number of shares of any other class or classes of stock of the Company, whether by capital reorganization, reclassification, or otherwise, the Holder shall be entitled to receive upon conversion of this Note, in lieu of the Series X Preferred Stock which the Holder would have become entitled to receive but for such change, a number of shares of such other class or classes of stock of the Company equivalent to the number of shares of Series X Preferred Stock that would have been received by the Holder on conversion of this Note if the Note had been converted immediately before the change or exchange.

3.3 Reorganizations, Mergers, Consolidations or Sale of Assets. If at any time there shall be a reorganization affecting the Company's Series X Preferred Stock (other than a reclassification or exchange of shares provided for in Section 3.2) or a merger or consolidation of the Company into or with another corporation, or the sale of all or substantially all of the Company's properties and assets to any other person (each, a "**Corporate Transaction**"), then, as a required term of such Corporate Transaction, lawful provision shall be made so that the Holder shall thereafter be entitled to receive upon conversion of this Note the number of shares of stock or other securities or property to which the Holder would have been entitled on such Corporate Transaction if this Note had been converted immediately before that Corporate Transaction. In any such case, appropriate adjustment shall be made in the application of the provisions of this Note with respect to the rights of the Holder after the Corporate Transaction in order to ensure that the provisions of this Note (including adjustment of the Conversion Price then in effect and the number of shares purchasable upon conversion of this Note) shall be applicable after the Corporate Transaction as nearly equivalent as may be practicable.

3.4 Notice of Adjustments. The Company shall promptly give written notice of each adjustment or readjustment of the Conversion Price or the number of shares of Series X Preferred Stock or other securities issuable upon conversion of this Note, by first class mail, postage prepaid, to the registered Holder. The notice shall fully describe that adjustment or

readjustment and show in reasonable detail the facts on which that adjustment or readjustment is based.

3.5 No Change Necessary. The form of this Note need not be changed because of any adjustment in the Conversion Price or in the number or class of securities or property issuable upon its conversion. A Note issued after any adjustment on any partial conversion or upon replacement may continue to express the same Conversion Price as is stated in this Note as initially issued, and that Conversion Price shall be considered to have been so changed as of the close of business on the date of adjustment.

3.6 Reservation of Stock. The Company shall at all times reserve and keep available, solely for issuance upon conversion of this Note, all shares of its Series X Preferred Stock from time to time issuable upon conversion of this Note. If at any time the number of authorized but unissued shares of Series X Preferred Stock shall not be sufficient to effect the conversion of this Note, the Company will take such corporate action as may, in the opinion of its counsel, be necessary to increase its authorized but unissued shares of Series X Preferred Stock to such number of shares as shall be sufficient for such purpose.

3.7 No Impairment. The Company will not avoid or seek to avoid the observance or performance of any of the terms to be observed or performed hereunder by the Company, but will at all times in good faith assist in the carrying out of all the provisions of this Section 3 and in the taking of all such action as may be necessary or appropriate in order to protect the conversion rights of the Holders of this Note against impairment.

4. Company Representations

The Company represents and warrants to the Holder as follows:

(a) **Organization and Standing.** The Company is a corporation duly organized and validly existing under the laws of the State of [BORROWER'S STATE OF INCORPORATION]. The Company has full power and authority under applicable corporate law to own, lease and operate its properties and to carry on its business as presently conducted and as proposed to be conducted. The Company is qualified to do business in all jurisdictions in which it is required to be so qualified under applicable law.

(b) **Authorization.** The execution, delivery and performance of this Note by the Company has been duly authorized by all requisite corporate action, and this Note constitutes the legal, valid and binding obligation of the Company enforceable in accordance with its terms, subject as to enforcement of remedies to applicable bankruptcy, insolvency, reorganization or similar laws relating to or affecting the enforcement of creditors' rights. The execution, delivery and performance of this Note and compliance with the provisions hereof by the Company do not conflict with or result in breach or violation of the terms, conditions or provisions of, or constitute a default (or an event with which the giving of notice or passage of time, or both, could result in a default) under, or result in the creation or imposition of any lien pursuant to the terms of, the Certificate of Incorporation or the Bylaws of the Company.

[Note: It is important to confirm that the Company has taken all necessary corporate action to authorize the issuance of the Note

and that there are enough shares reserved for conversion of the Note. If the Note will convert to preferred stock, there should also be enough common stock reserved to convert into common stock the preferred stock received upon conversion of the Note.]

5. Holder's Representations

The Holder hereby represents and warrants to the Company that, at and as of the date of this Note and at and as of the date of conversion, each of the following statements is and shall be true and correct in all respects:

5.1 Authority. The Holder has all requisite legal power to enter into this Note, to purchase the Note hereunder and to perform its obligations under the terms of this Note.

5.2 Authorization. This Note, when executed and delivered by the Company, constitutes a valid and legally binding obligation of the Holder, enforceable in accordance with its terms, except as enforcement may be limited by applicable bankruptcy laws or other similar laws affecting creditors' rights generally, and except insofar as the availability of equitable remedies may be limited.

5.3 Investment Representations. This Note is made with the Holder upon the understanding, as a specific representation to the Company by the Holder, that:

(a) The Note purchased hereunder and any securities to be issued upon conversion of the Note will be acquired for the Holder's own account, not as a nominee or agent, and not with a view to the distribution of any part thereof. The Holder has no present intention of selling, granting participation in or otherwise distributing the same.

(b) The Holder understands that neither the Note nor any securities to be issued upon conversion of the Note have been registered under the Act or any state's securities laws by reason of reliance upon certain exemptions therefrom, and that the reliance of the Company on such exemptions is predicated upon, among other things, the bona fide nature of the Holder's investment intent as expressed herein.

(c) The Holder is an "accredited investor" as that term is defined in Rule 501 of Regulation D promulgated under the Act.

[Note: The Holder makes these representations and warranties in order to establish appropriate securities law exemptions for issuing the Note.]

5.4. Restrictions on Transfer. The Holder acknowledges that no sale, transfer, assignment, hypothecation or other disposition of this Note or the Conversion Stock shall be made in the absence of (a) current registration statement under the Act as to this Note or the Conversion Stock and the registration or qualification of this Note or the Conversion Stock under any applicable state securities laws is then in effect or (b) an opinion of counsel reasonably satisfactory to the Company to the effect that such registration or qualification is not required. Each certificate or other instrument representing Conversion Stock shall, if required under the

Act or the rules promulgated thereunder, be imprinted with a legend substantially to the foregoing effect.

5.5 No Rights, Preferences, or Privileges. The Holder understands, acknowledges and agrees that, so long as the Note remains outstanding, the Holder shall not hold or be entitled to exercise any rights, preferences or privileges generally held by a stockholder as to the shares into which this Note is convertible. The Holder shall be entitled to exercise all the rights, preferences and privileges of a stockholder of this Company only upon the conversion of this Note, pursuant to the conditions set forth herein, and upon the Company's issuance of a stock certificate and transfer into the Company's stock ledger of the Holder's equity interest.

6. Additional Covenants

[Note: This section may include any number of restrictions upon the Company as required by the investors.]

6.1 Further Assurances. Each party agrees and covenants that at any time and from time to time it will promptly execute and deliver to the other party such further instruments and documents and take such further action as the other party may reasonably require in order to carry out the full intent and purpose of this Note.

6.2 Debt Restriction. While this Note is outstanding, the Company shall not issue any debt security, whether or not convertible into shares of capital stock of the Company, which is not subordinate in payment to this Note.

7. Events of Default; Security

7.1 Event of Default. Upon the occurrence of an Event of Default as defined in the Security Agreement, the Holder may declare the entire unpaid principal and accrued interest on the Note immediately due and payable, by a notice in writing to the Company; provided, however, that upon the occurrence of an Event of Default described in Section 9(e) of the Security Agreement, the entire unpaid principal and accrued interest on the Note shall become immediately and automatically due and payable without any requirement of notice.

[Note: When counsel to the Holder, include a default provision allowing the Holder to accelerate the payment obligation evidenced by the Note in the event of a bankruptcy, receivership or insolvency proceedings.]

7.2 Security for Obligations. This Note is secured by the Security Agreement.

[Note: Bridge loans are typically unsecured. Investors may, however, demand security depending on the circumstances. In that case the loan may be secured by a pledge of assets or stock under a security agreement. If this is an unsecured note, delete all references to security, "Secured" in the heading of the Note and Section 7.2.]

8. Transfer

Subject to the restriction set forth in Section 5.4, this Note and all rights hereunder are transferable to one or more persons or entities, in whole or in part, at the principal office of the Company, by the Holder in person or by duly authorized attorney or agent, upon surrender of this Note properly endorsed.

[Note: The Company may wish to limit partial transfers to certain minimum amounts in order to avoid the expense of administering multiple smaller notes, and warrants, if any, held by multiple holders.]

9. Miscellaneous Provisions

9.1 Governing Law. This Note shall be governed in all respects by the laws of the State of [STATE WHERE BORROWER HAS PRIMARY PLACE OF BUSINESS OR STATE OF BORROWER'S INCORPORATION] without regard to the principles of conflicts of laws thereof.

9.2 Successors and Assigns. The provisions hereof shall inure to the benefit of, and be binding upon, the successors, assigns, heirs, executors and administrators of the parties hereto.

9.3 Entire Agreement. This Note, the Security Agreement and the Warrant constitute the full and entire understanding between the parties with regard to the subjects hereof. Any term of this Note may be amended and the observance of any term of this Note may be waived (either generally or in a particular instance and either retroactively or prospectively) only with the written consent of the Company and the Holder. No previous waiver and no failure or delay by the Holder in acting with respect to the terms of this Note and the Security Agreement shall constitute a waiver of any breach, default or failure of condition under this Note or the Security Agreement or the obligations secured thereby.

9.4 Notices and Other Communications. All notices, advices and communications to be given or otherwise made to any party to this Note shall be deemed to be sufficient if contained in a written instrument delivered in person or by or duly sent by first class registered or certified mail, return receipt requested, postage prepaid, or by overnight courier, or by electronic mail, with a copy thereof to be sent by mail (as aforesaid) within 24 hours of such electronic mail, addressed to such party at the address set forth below or at such other address as may hereafter be designated in writing by the addressee to the addresser listing all parties:

(a) If to the Company, to:

[BORROWER]
[BORROWER'S ADDRESS]
Attention:
Facsimile:

(b) If to the Lender, as follows:

[LENDER]
[LENDER'S ADDRESS]
Attention:
Facsimile:

or to such other address as the party to whom notice is to be given may have furnished to the other parties hereto in writing in accordance herewith. Any such notice or communication shall be deemed to have been delivered and received (i) in the case of personal delivery or delivery by telecopier, on the date of such deliver, (ii) in the case of nationally-recognized overnight courier, on the next business day after the date when sent and (ii) in the case of mailing, on the third business day following that on which the piece of mail containing such communication is posted. As used in this Section 9, "business day" shall mean any day other than a day on which banking institutions in the State of California are legally closed for business.

9.5 Severability. If any provision of this Note shall be invalid, illegal or unenforceable, the validity, legality and enforceability of the remaining provisions shall not in any way be affected or impaired thereby.

9.6 Counterparts. This Note may be executed in counterparts. Execution and delivery of this Note by exchange of facsimile copies bearing the facsimile signature of a party hereto shall constitute a valid and binding execution and delivery of this Note by such party. Such facsimile copies shall constitute enforceable original documents.

9.7 Attorneys' Fees. If any action or proceeding shall be commenced to enforce this Note or any right arising in connection with this Note, the prevailing party in such action or proceeding shall be entitled to recover from the other party the reasonable attorneys' fees, costs and expenses incurred by such prevailing party in connection with such action or proceeding or negotiation to avoid such action or proceeding.

9.8 Headings. All headings used herein are used for convenience only and shall not be used to construe or interpret this Note. Except as otherwise indicated, all references herein to Sections refer to Sections hereof.

* * *

The Company has caused this Note to be issued as of the date first set forth above.

[BORROWER]

By: _____
Name:
Title:

ACCEPTED AND AGREED:

[LENDER]

By: _____
Name:
Title:

NOTICE OF CONVERSION

(To Be Signed Only Upon Conversion of Note)

TO _____

The undersigned, the holder of the foregoing Note, hereby surrenders such Note for conversion into shares of capital stock designated as “_____” of _____ to the extent of _____ dollars (\$_____) unpaid principal amount of such Note and interest thereon, and requests that the certificates for such shares be issued in the name of, and delivered to, _____, whose address is _____.

Dated: _____, 200__.

(Signature must conform in all respects to name of holder as specified on the face of the Note)

(Address)

ATTACHMENT 4

RECENT SELECTED PRIVATE EQUITY FINANCING RELATED ARTICLES

ATTACHMENT 5

NETWORKING GROUPS LIST (HANDOUT)