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**CPA's guide to small business financing**

Robert (Robert William) Walter

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The CPA's Guide to Small Business Financing

Robert W. Walter, J.D.
DEDICATION

For my wife Anne and children Lindsey, Stephanie and Robby

For my mother Patricia, whose love of reading led to my own
ABOUT THE AUTHOR

Robert W. Walter is a partner in the law firm of Berliner Zisser Walter & Gallegos and has counseled small business clients with respect to securities and corporate matters for over 20 years. He has represented a broad spectrum of private and public businesses in a wide variety of equity and debt financings, as well as a number of investment banks active in underwriting small business public offerings and private placements. Mr. Walter has authored several courses on securities regulation and finance for the American Institute of Certified Public Accountants (AICPA) and has instructed these and other securities courses throughout the country and internationally for the AICPA. He has also authored articles on securities liability of accounting firms.

In August 2002, Commerce Clearing House (CCH) Incorporated published Financing the Small Business, a reference work authored by Mr. Walter for corporate counsel. He has entered into a publishing agreement with Barron’s, which will publish Small Business Financing: From Startup to Sale, for the consumer market in the second quarter of 2003 under its Barron’s Business Library series. CCH will publish Mr. Walter’s next reference work for securities lawyers in November 2002, entitled Small Business IPOs: From Concept to Closing. Mr. Walter is currently authoring Corporate Ethics for Financial Managers and Accountants: Case Studies, Guidance and Avoiding Pitfalls, which will be published as a reference work and a continuing education course by the AICPA in December 2002.

Mr. Walter received his Juris Doctor degree from the Duke University School of Law and a Bachelor of Science degree from Colorado State University. Mr. Walter endowed the Robert William Walter and Robert Wheaton Walter Scholarship at the Duke University School of Law in 1987 in honor of his father. Mr. Walter is a member of Mensa International Limited.

Comments or questions concerning this book may be forwarded to Mr. Walter at his e-mail address at bwalter@bzwg.com.
I owe special thanks to my wife Anne, and children Lindsey, Stephanie and Robby, for their unremitting patience while I was writing this book. I also want to thank my assistant Erika Cwetna and my partners at our firm for their support during the course of the writing and editing process.

I also want to thank Ross Nelle from the AICPA, whose technical and other support was instrumental in my development of the course materials referenced below. Additionally, special thanks go to Olivia Lane from the AICPA, who was responsible for spearheading the publication of this book.

The author and the publisher also wish to acknowledge that this work is derived in principal part from a continuing professional education course written by the author in 2002 for the AICPA entitled, "AICPA's Guide to Financing the Growing Small Business: Sources, Strategies and Disclosures," and has been adapted by permission. A separate work drawn primarily from this professional education course that is entitled Financing the Small Business has been published by Commerce Clearing House, Inc., for legal practitioners.
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PREFACE

When most entrepreneurs form a business or develop new products or processes, the concept of raising outside capital may be the furthest thing from their thoughts. Then, either suddenly or over time, the business or technology begins to take on a life of its own. The entrepreneur begins to contact potential customers, a few friends or acquaintances learn of, or may invest in, the start-up business, and sales commence or appear imminent. Planned growth materializes and begins to drive the business and its cash needs.

Around this time, the entrepreneur contacts his or her professionals and starts examining issues such as selecting the right entity through which to conduct business and what kind of capital structure is most appropriate. The business may expand through the addition of management team members with financial, sales and technology expertise. If the business addresses a need in the market, or if the technology provides benefits over and above existing products or processes, the entrepreneur often finds that the success of the business begins to outpace available resources.

At this point, the entrepreneur asks the accountant for advice on issues such as:

- How do I fund the business's cash needs? How long will it take to get financing?
- How do I value the business? How will outsiders value the business?
- Should I raise equity or debt? Why one versus the other?
- What are the best sources for financing? How do I find them? Which are right for my business?
- Is there anything I should do now to improve my chances of closing a financing?
- What kinds of documents are used for a financing? What should I watch out for?
- How involved will the investor be in my business? Will I lose control?
- What post-closing obligations will I owe to outsiders?
This book is designed to furnish answers to these and other commonly and not-so-commonly asked questions that are encountered in the financing process for a small business. The book explores these subjects in the context of the corporate life cycle—from formation to sale or merger—which recognizes that certain types of financing are more appropriate, and less costly, for small businesses in different stages of development. The book describes methods, warnings, tips, example-type-situations, and advantageous techniques for financing any type of business. A brief summary of the topics addressed in each Chapter is provided below.

Examples of documents from “real life” transactions have been included as appendices to frame the discussion of various issues and to enhance the understanding and relevance of the materials. CPAs in industry and public practice, as well as consultants, can use the appendices as reference points when evaluating financing documentation tendered to the company or client in similar transactions.

Chapter 1 provides an overview of the various types of the most common financing vehicles available to small businesses. The different forms of financing are broken down in equity and debt categories and include a detailed discussion of the attributes of, among other instruments, preferred stock and debt. Chapter 1 also introduces the concept of the corporate life cycle and classifies financing options by:

- stage of development;
- equity or debt financing; and
- sources of funding.

In Chapter 2, the knowledge base established in Chapter 1 is expanded upon by building an understanding of why certain financings are more advantageous than others in various stages of development. Advantages are not merely limited to a discussion of out-of-pocket costs, but encompass issues such as dilution, valuation, and timing. This Chapter also discusses some of the events that may delay a closing and how to anticipate issues that often surface in the course of a financing. Specific advantages and disadvantages of different financing options are discussed, and a sample term sheet from a venture capital firm is included for review.

Having reached an understanding of the various forms of financing that are available to a small business at different points in time, and the advantages and disadvantages inherent in these financings, Chapter 3 covers how to identify potential financing sources. The materials offer a number of Web-based resources available to the small business management team and its professionals that can be used to develop financing alterna-
tives. This Chapter also addresses the objectives of different investor types and offers insights designed to help the small business management team and its advisors understand the thinking of prospective investors.

Chapter 4 covers the preparation of the business plan and the key issues that investors will want to address prior to issuing a term sheet or letter of intent. In addition, the contents of typical term sheets and letters of intent issued by investors and investment bankers are included for review and evaluation.

This Chapter also introduces information that will assist the reader in developing a timeline to closing the financing. When the corporation reaches the point of executing a term sheet or letter of intent, the time to closing will be defined by what compliance, due diligence and "deal breaking" issues are yet to be resolved and the time needed to prepare and negotiate definitive documents. This Chapter covers the period from the point management decides to seek financing to when the corporation obtains a preliminary commitment, while Chapters 5, 6 and 7 address the issues and documentation from the point of the preliminary commitment to the closing of the financing. In effect, all of these Chapters are a chronology of the key events that may be encountered in the financing process.

Chapter 5 delves into the disclosure issues that fall under the general heading of compliance. Among others, this Chapter considers the types of disclosure documents used, and financial statements delivered, in different financing transactions. The issues surrounding a prior failure to comply with relevant disclosure requirements, together with suggestions for different means of addressing such a failure, are also discussed. However, the emphasis here is on preventive measures that should be taken to ensure that compliance is achieved and maintained.

"Deal breaking" issues are considered in Chapter 6, including valuation, due diligence, anti-dilution, employment and stockholder agreements, corporate governance and other investment terms. This Chapter examines some of the typical difficulties associated with these issues and offers suggestions concerning alternative resolutions for problems arising in these categories. Since ancillary agreements such as stockholder agreements and registration rights agreements are often used to import material terms into an investment agreement, the content of these ancillary agreements is analyzed and samples are provided for review.

The contents of customary equity and debt purchase agreements are examined in Chapter 7. In general, these agreements include the amount and terms of the financing, historical information (representations and warranties), forward-looking information (covenants), exceptions disclosed by schedule or exhibit, and provisions regarding default, remedies and
indemnities. As indemnities and hold harmless agreements may be used as either “a shield or a sword,” a portion of this Chapter is devoted to a careful review of these clauses with the potential to change the fundamental economics of the transaction.

The issues of compliance with covenants, as well as the importance of maintaining good post-closing communication, are addressed in Chapter 8. This Chapter also considers exit strategies that may be available for the small business, many of which will have been discussed with outside investors in the course of prior financing transactions. As some private investors maintain “puts” on equity instruments, or provide debt financing with penalty clauses that will increase the effective cost of capital, the review of available exit strategies is placed in a context that emphasizes advance planning and consideration of less costly refinancing alternatives where accessible.

Robert W. Walter
Denver, Colorado

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**PowerPoint Presentation**

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CHAPTER 1

IDENTIFYING FINANCING OPTIONS AVAILABLE TO GROWING SMALL BUSINESSES

This Chapter provides a detailed review of the types of financing that a small business should consider using when seeking financing from outside sources. Both equity and debt financings are covered, as well as the most common types of financing within these general categories. The corporate life cycle\(^1\) is used in *The CPA's Guide to Small Business Financing* as a means of identifying the financing types and sources that are most appropriate (and less costly) for differing small businesses. Since planning issues and capital needs adjust as a business ages, the financing alternatives are approached from different stages in the life cycle of a growing small business.

**EQUITY INSTRUMENTS**

Equity is the most common instrument issued to finance small businesses. Equity is generally issued in the form of common stock or preferred stock, although some small businesses issue equity in the form of units that may

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\(^1\) *Author’s Note.* This discussion presumes that the small business is operated as an “S” corporation (until no longer eligible as such) or a “C” corporation and does not address other forms of organization such as limited liability companies, limited partnerships, limited liability limited partnerships, or similar entities. If the small business is engaged in operations that involve real estate or that otherwise require the use of a “pass through” entity, the form of organization may dictate the availability or lack of availability of certain types of financing. Since the vast majority of small businesses other than those engaged in real estate activities are organized initially, or later reorganized, as corporations, this publication presents information that assumes use of a corporate entity. Choice of entity involves complex business, legal, and accounting determinations that are the subject of other publications and that should be made only in consultation with a small business’s professionals.
include a combination of common stock, preferred stock, warrants or rights, or even debt instruments. The rights and preferences assigned to preferred stock can vary widely, meaning that preferred stock may be considered an "equity equivalent" in one issuance and a "debt equivalent" in another. This flexibility is one reason that venture capital investors will generally make small business investments through purchases of preferred stock, thus allowing the venture investor to customize the form of the investment to their liking. Equity may also be issued in the form of options to acquire stock during a specific period of time upon vesting, although option issuances are customarily limited to employees, directors and consultants that are actively employed by, or providing services to, a small business. Equity is generally issued:

- First to founders, management, employees, and consultants;
- To "angel" investors, venture capital firms, private equity groups or strategic partners;
- In private offerings or "private placements" to individual and/or institutional investors; and
- In public offerings.

The following are the key characteristics of equity instruments issued in financings of small business corporations.

**COMMON STOCK**

Common stock is the basic form of ownership, as well as equity, in a corporation. It is issued to investors in return for contribution of capital or for other consideration, such as property or services. Common stock stands to lose the most or gain the most, as compared to all other forms of securities, from the results of operations of the business. The distribution of dividends is at the discretion of the board of directors, excepting a special provision in the certificate of incorporation to the contrary. Dividends on common stock are not paid until after debt service and dividends on senior securities such as preferred stock have been paid. There is no maturity date on common stock, with the result that common stockholders remain as interest holders until liquidation or occurrence of a liquidity event such as a sale of the business, merger, or public offering. Common stock ownership in a private company is generally considered to be a risky investment due to the absence of a liquid market and the lack of assurance that a liquidity event will occur in the foreseeable future.

Every corporation must have at least one class of common stock. Various classes of common stock may be created by a small business providing for, among other things:
• Veto rights over specified corporate actions;
• Greater than a majority quorum and voting requirements at both, or either of, the director and stockholder level; and
• Enhanced voting rights that permit the founders or management to retain voting control even as additional capital is raised through the sale of non-voting or limited voting common stock.

Preferred Stock

Preferred stock has some of the attributes of common stock and some of the features of debt and, depending on the rights and preferences attached to it, may be “designed” to be similar to equity or vice versa. The rights and preferences are established in the certificate of rights and preferences that is filed in the state of the corporation’s organization, although some rights may be set forth only in the preferred stock purchase agreement or a stockholder agreement. The principal rights and preferences that define preferred stock include the following:

• Participating vs. Non-Participating—Preferred stock is typically “non-participating” meaning it, like debt instruments, is limited to dividends at a fixed rate regardless of the amount of corporate earnings or the amount of dividends paid on common stock. On the other hand, preferred stock may be made “participating,” allowing for such stock to share in the total earnings and profits of the corporation on the same basis as that of the common stockholders.

• Cumulative vs. Non-Cumulative—Dividends may be described as “cumulative” or “non-cumulative.” Cumulative dividends continue to accrue whether the corporation has the funds available to distribute the dividend or not. At such time as the corporation has the funds available and may legally distribute the dividend, the corporation is required to do so by the terms of the preferred stock. Non-cumulative preferred stock has a stated dividend but, if the corporation lacks the ability to fund the dividend or other factors prohibit its distribution (such as covenants imposed by senior debt), the dividend does not accrue and is never issued if not declared by the board of directors.

• Convertibility—Most often a conversion right provides for the conversion of preferred stock into common stock of the issuer, known as a downstream conversion. A downstream conversion is usually exercised when the market price of the common stock has appreciated above the preferred stock’s stipulated conversion price. An upstream conversion, which is rarely used, is an exchange of preferred stock for debt when the rate of return on the debt is higher than the rate at which dividends are being paid on the preferred stock. Conversion features may also include optional or required conversions upon occurrence of specified events, such as liquidity events, or after the passage of time.
Voting—Preferred stock purchasers are often given the right to vote their preferred stock on an “as converted” basis at meetings of stockholders of the corporation. The preferred stockholder may also retain the right to vote the preferred stock as a class with respect to designated corporate transactions such as stock dividends, acquisitions, future issuances of securities, and changes in the board of directors. To the extent any of these transactions require approval of all classes of stock entitled to vote on the transaction, the preferred stockholder may have, in effect, a veto over the completion of the transaction. The preferred stock terms may also require a supermajority of the preferred stockholders (if more than one) to approve corporate transactions such as those described above, or to agree to any changes in the rights and preferences of the preferred stock.

Liquidation Preference—It is usually the case that preferred stock has a liquidation preference that entitles the preferred stockholders to receive distributions of assets in a liquidation ahead of all classes of common stock. The value of such preference may be negligible in the case of involuntary liquidation, where the liquidated corporation rarely has excess capital to distribute to holders of equity. To the contrary, the preference may be of considerable value to the preferred stockholder in the event of a voluntary liquidation. Liquidation preferences may be designed such that the corporation is required to pay cumulated and unpaid dividends prior to the distribution of assets in liquidation to the holders of common equity. This may also apply to liquidating distributions on sale of all of the assets of the corporation.

Ranking—Ranking is typically an issue when a corporation has issued more than one series of preferred stock, or has instruments outstanding that are convertible into additional series of preferred stock. In this case, the relative rights of the holders of preferred stock are stipulated in the references to ranking that are contained in the certificate of rights and preferences. Thus, if a corporation issues Series A 10% Convertible Preferred Stock and Series B 11% Non-Convertible, Cumulative Preferred Stock, the certificate of rights and preferences for the Series A will provide that the Series A is senior in rights as to dividends and liquidation preferences to any other series of preferred stock or the common stock. If the purchaser of the Series B has successfully negotiated a senior ranking, the certificate of rights and preferences for the Series B would refer to the senior ranking and, in all likelihood, the certificate of rights and preferences for the Series A would have to be amended to delete any inconsistent language.

Anti-dilution rights—The function of anti-dilution rights is to maintain the percentage ownership of the preferred stockholder in the corporation on occurrence of specified events. These rights protect against dilution
in ownership interest arising from corporate events such as stock splits and stock dividends, including splits and dividends on the common stock. In these circumstances, the preferred stock is generally given anti-dilution protection on an “as if converted” basis. In its more expansive use, anti-dilution clauses will preserve the ownership interest of the preferred stockholder at a specified level if the corporation issues common stock or preferred stock convertible into common stock if the issuance or conversion price is lower than the issuance or conversion price of the previously outstanding preferred stock. This form of anti-dilution protection is referred to as “price anti-dilution” and can be very dilutive to the stockholders of the corporation that lack this protection if the corporation is forced to engage in multiple rounds of financing at lower prices than paid for the initial round of preferred stock.

- **Rights of First Refusal**—These rights vary considerably but are usually classified as rights to acquire the *pro rata* share of any subsequently issued security that is issued at a per share price higher than the per share price of outstanding preferred stock. These rights may also extend among the holders of preferred stock, such that if one preferred stockholder declines to purchase its *pro rata* share of the offered security, the remaining preferred stockholders have a right of first refusal to purchase the declining preferred stockholder’s *pro rata* share. These rights may extend for a specified period of time, for up to a specified dollar amount of subsequent financings, or until occurrence of a conversion or liquidity event.

- **Registration Rights**—Described as either “piggyback” or “demand,” these rights come into existence at the time the corporation becomes a public company and extend for a period of time thereafter, usually between three and five years. In the case of *piggyback rights*, the preferred stockholder generally converts its preferred stock to common stock and is permitted to “piggyback” the common stock onto a registration statement that the corporation is filing to register stock for its own purposes. The piggyback right is often timed to become exercisable six months or more after the completion of the public offering in order to allow the market for the corporation’s common stock to stabilize and to avoid the perception of a significant stock overhang in the period immediately after the public offering. As long as the corporation does not file a registration statement after the piggyback right becomes exercisable, the piggyback right is not triggered. Demand rights differ from piggyback rights in that the preferred stockholder has the right, during or after the time the corporation’s common stock becomes publicly traded, to *demand* that the corporation register the common stock into which the preferred stock was, or is to be, converted.

Both demand and piggyback rights are generally *exercisable at the corporation’s expense*. This means that the corporation pays all expenses of
registering the common stock held by the converting preferred stockholder, including legal, accounting and filing fees, printing expenses, and exchange listing fees. Generally, the only expense paid by the preferred stockholder is the commission incurred on sale of the shares after their registration. As could be expected, a demand right is considerably more expensive than a piggyback right if the corporation has to prepare a new registration statement in order to register common stock issuable on conversion of preferred stock. For this reason, corporations seek to limit the number of demand registration rights granted to preferred stockholders and are typically more willing to provide unlimited piggyback rights over a specified period of time.

- **Equity “Claw-Backs”**—Equity “claw-backs” are usually described in the stockholder agreement that the parties execute at the closing of the preferred stock investment. Equity claw-backs are customarily given only to the management team and enable its members to increase their equity percentage ownership of the corporation (thereby reducing even the percentage of ownership of the preferred stock investor, which is usually not given anti-dilution protection from the effect of the claw-back) if the corporation is successful in exceeding pre-established revenue, operating income, EBITDA, net income or other benchmarks. While the same effect can be achieved by a grant of additional stock options to the management team that vest on achievement of the performance benchmarks, limitations created by the number and exercise prices of options, and the practical difficulties of maintaining an unusually large stock option plan at and following a public offering, often mandate use of a claw-back. This is true also when management is particularly sensitive to their percentage ownership and the management team perceives the claw-back as a means of “leveling the playing field” and obtaining a more desirable valuation if they are successful in achieving the targeted results.

- **Rachet clauses**—Rachets are used by venture and private equity firms to increase their percentage of equity ownership and/or to reduce the conversion price of their preferred stock (which in effect will increase their percentage of equity ownership by increasing the number of shares of common stock issued on conversion of the preferred stock). A rachet clause works in a manner similar to the equity claw-back, but acts to reduce the conversion price if the corporation is unsuccessful in meeting revenue, operating income, EBITDA, net income or other targets. A rachet clause will typically be used by the venture or private equity firm to “bridge” a valuation gap between the investor and the corporation and can be used to penalize the management team if it attempts to use projections in the valuation process that clearly seem unattainable to the investor. It is rare to see rachet clauses existing alongside equity claw-backs, simply because the failure to meet the target benchmarks can
have a two-fold effect on management's ownership, while success in meeting the benchmarks can double the dilution to the investor. If the small business is presented with a rachet clause, it should carefully evaluate the benchmarks and attempt to negotiate reasonable targets. If a term sheet has no rachet clause but management believes the offer reflects a valuation that is too low, the management team may wish to consider a counter offer with an equity claw-back in its own attempt to bridge a valuation gap. Again, the setting of the benchmarks is the key to management's ability to increase its ownership and should be very carefully considered before making a counter offer that includes a claw-back.

- "Tag-Along/ Drag-Along" Rights—Although these rights are generally set forth in the preferred stock purchase agreement or the stockholder agreement, their importance cannot be understated. "Tag-along" rights permit the preferred stockholder to "tag-along" in a sale of shares by the management team of the corporation or other significant stockholders or to participate on a pro rata basis if less than 50% of the corporation is sold to an outside buyer. In some instances, the tag-along rights are exercisable only upon conversion of the preferred stock into common stock, and in others the tag-along rights are exercisable by the preferred stockholder on an "as if converted" basis. "Drag-along" rights are the reverse of tag-along rights, and typically entitle the corporation to "drag-along" the preferred stockholder into a sale or partial sale of shares by the corporation, its management team or its significant stockholders. Drag-along rights are particularly important if the corporation has no right to force conversion of the preferred stock on occurrence of a liquidity event such as a sale of the business or its assets.

- Board Representation/Board Observer—The preferred stock purchase agreement or the stockholder agreement will typically provide for the right of the preferred stock purchaser to appoint one or more of the members to the board of directors of the corporation. Venture capital investors will generally seek to have significant board representation with the ability to increase that representation if there are changes in the management team or if the corporation fails to meet certain performance benchmarks. In some instances, concern about liability for actions taken as a board member will cause the preferred stock purchaser to request the right to designate an observer to the board of directors, rather than a member.

- Financial Covenants and Other Restrictions—In those instances where the preferred stock is considered by the investor to be equivalent to a debt instrument, the investor will frequently require the corporation to maintain certain financial ratios and meet designated financial criteria. In addition, the preferred stock purchase agreement will generally include a variety of covenants as to:
— The operation of the corporation;
— Financial reporting;
— Preparation of budgets;
— Delivery of specified information on a monthly or quarterly basis to the preferred stock investor;
— Management and board composition;
— Compensation and award of options and bonuses;
— Maintenance of insurance;
— Regulatory compliance; and
— Approval of related party transactions by disinterested members of the board of directors.

The covenants usually lapse on occurrence of a liquidity event, on conversion of the preferred stock into common stock or on liquidation.

**Debt Facilities**

Debt is classified as short term, that is, due in less than one year, and long term, maturing from two to seven years or perhaps longer. In general, short-term debt is comprised of the current portion of long-term debt unless the corporation has a revolving line of credit that renews annually. As a small business grows, it is often successful in securing a revolver that renews in two or three years, although banking practices vary considerably in this regard. All of the debt facilities discussed below are long term except revolving lines of credit that renew annually. As a small business grows and is successful in securing more than one type of debt financing, the revolver or term loan with a first lien on the corporation’s assets, typically provided by a bank, is referred to as “senior debt.” Debt facilities that have a lower lien priority than senior debt are referred to as “subordinated debt,” but may take a variety of forms such as term debt, mezzanine debt, or convertible debentures, all of which are discussed below. Subordinated debt is most often provided to small businesses by non-bank sources, such as:

- “Mezzanine” funds;
- Private equity funds, including Small Business Investment Companies (SBICs);
- Institutional investors;
- Strategic partners; and
- Unregulated subsidiaries of banks and other financial institutions.

For more on financing options within different stages of development, see Chapter 2, “The Advantages, Disadvantages, and Timing Issues Associated with Alternative Financings.” Chapter 3, “Locating the Right Investors
and Understanding Their Objectives,” provides assistance and tools to identify financing sources and understand their objectives.

**Overview of Common Elements of Documents Governing Debt Financing**

In general, documentation of credit facilities obtained from a majority of lenders will share most, if not all, of the following attributes:

- An aggregate credit limit based on eligible borrowings against a borrowing base calculated as a percentage of receivables, inventory, or other assets or a specified loan amount; in addition, minimum availability and the maximum amount of initial amounts outstanding at the time the facility is established;
- A description of the use of proceeds of the credit facility;
- A description of the collateral, including whether guarantees or support agreements from founders or management are required;
- The initial rate of interest, the default rate of interest, any adjustment formula if the interest rate is variable, and any minimum interest charges;
- Specification of the commitment fee, fees on any unused portion of the facility, closing fees, collateral audit fees (including initial fees and any on-going monthly or quarterly collateral audit fees), letter of credit fees, facility fees, early termination fees, and legal fees of the financing source to be paid by the borrower;
- The term of the borrowing, required paydowns, and any prepayment fees;
- Specification of expenses payable by the borrower, including appraisal fees, UCC search and recording fees, credit report costs, lockbox costs, real estate title searches and recording fees, and expenses of environmental surveys;
- A description of the financial reporting requirements of the borrower to the financing source, including whether annual audited financial statements are required;
- Representations and warranties as to basic corporate governance matters, including due and valid organization, qualification to do business in jurisdictions, authorization to secure the credit facility, absence of litigation and regulatory proceedings, absence of environmental issues, priority of lien to be granted to the financing source, absence of undisclosed liabilities, and good title to the collateral to be pledged;
- Financial covenants including debt to equity, tangible net worth, fixed charge coverage, mandatory debt retirement, current ratio, loan to value, and similar ratios; in addition, covenants relate to financial reporting, guarantees of the obligations of subsidiaries or third parties, acquisitions, stock repurchases, dividends and distributions, compensation, change in management, capital expenditures, disposition of assets, and transactions with affiliates;
A description of occurrences that constitute events of default, such as payment defaults, non-compliance with warranties or covenants, insolvency, bankruptcy, change of control, cross defaults, judgment defaults, and similar events;

- Receipt of intercreditor or subordination agreements satisfactory to the lender; and
- Receipt of legal opinions, audit opinions, comfort letters, and appraisals satisfactory to the lender.

Revolving Lines of Credit are used to fund current operations and are generally secured by accounts receivable, inventory, cash and its equivalents and, in most cases, by substantially all of the assets of the corporation. Revolvers are often repaid from the proceeds of a term loan or an equity financing. The three major expenses frequently associated with this form of financing include (1) an interest cost that is normally tied to the bank's prime rate or the bank's cost of funds, (2) a compensating balance, usually about 10% of the outstanding balance or the total committed credit line, which is held by the bank in a non interest-bearing account, or (3) limitations in the borrowing base established by advance rates of less than 100% against receivables, inventory or other assets.

Term loans require scheduled periodic payments of principal and interest over the term of the loan. These loans are commonly used to increase working capital, to finance a major expansion of capital facilities or acquire another business. Compared to short-term loans, these loans are more risky because the longer term decreases the certainty of repayment, sometimes resulting in higher interest rates.

Small Business Administration (SBA) loans are loans that require an applicant to have sought financing from a bank or other lending institution before being eligible for SBA loan assistance. There are two basic types of SBA loans:

1. Guarantee loans. These loans are the most common SBA loans and provide for:
   - Loans made by private lenders that are guaranteed up to 90% by the SBA;
   - The maximum guaranteed percentage of loans exceeding $155,000 is 85%; and
   - A maximum guarantee of $750,000 by the SBA.

The initial review of the loan application is made by the lender. If the lender approves the application, it is submitted to the local SBA office and if approved by the SBA, the lender closes the loan and disburses the funds. Although limited in amount, SBA-guaranteed loans offer the corporation lower interest costs than non-guaranteed loans due to the lender's receipt of the SBA guarantee of repayment. Accordingly, small businesses are wise to consider this means of financing where available.
Chapter 1: Identifying Financing Options

2. Direct loans:
   • Loans that have an administrative maximum of $150,000 and are available only to applicants unable to secure an SBA-guaranteed loan; and
   • An applicant must first seek financing from his/her bank of account and, in cities of over 200,000, from at least one other lender before applying for an SBA direct loan.

SBA direct loan funds are limited and are often available only to businesses that fit a certain profile (e.g., businesses located in high-unemployment areas or owned by low-income individuals, minorities, handicapped individuals, or veterans).

*Mezzanine Loans* are an intermediate level in the funding of a corporation and may effectively serve as a combination of debt and equity. While mezzanine financing often refers to subordinated debentures or notes that are secured to finance acquisitions, it may also be used to fund internal growth. The debentures or notes issued in a mezzanine financing are often delivered in conjunction with options or warrants to acquire shares of common stock in the corporation. The options or warrants may carry a nominal exercise price or an exercise price close to the fair market value of the common stock, depending on the other terms and conditions attached to the mezzanine financing.

For example, if the mezzanine financing carries an interest rate closer to that of a high yield bond, or if the number of warrants is low relative to the number of outstanding shares of common stock, the exercise price of the warrants may reflect these facts by being fairly low. On the other hand, a lower interest rate or an increased number of warrants may imply a higher exercise price for the warrants. The “equity equivalent” component of the mezzanine financing is typically determined by negotiation between the lender and the corporation and ultimately reflects the lender’s calculation of how it will achieve its targeted rate of return. See Chapter 3, “Locating the Right Investors and Understanding Their Objectives,” that addresses this calculation in more detail.

*Convertible Debt* is a less common form of mezzanine financing that:
   • Gives the lender the right to convert all or part of a loan into common stock for a stated period at a specified rate of exchange up to and including the date of maturity;
   • Carries a lower interest rate than nonconvertible debt, thus reflecting the enhanced rate of return possible on conversion;
   • Is typically subordinated and unsecured or, if the financing relates to acquisition of specific assets, may only be secured by the acquired assets; and
   • Tends to be used by smaller companies with high growth rates and a more leveraged capital structure.
Convertibles are a form of mezzanine financing in that the debt financing obviously has an equity component built in through the conversion feature. Due to the inherent uncertainty of whether conversion will take place and the dilution that the corporation may experience on full conversion, convertibles are less commonly used in mezzanine financings for small businesses than debentures or notes issued with attached warrants or options.

High Yield Debt, more commonly known as “junk bonds,” carries extremely high interest rates and is subordinate to virtually all other debt obligations of a corporation. High yield debt is unrated or receives the lowest non-investment grade ratings from bond rating agencies and is considered to be extremely high risk. While small businesses may occasionally be successful in securing financing through the issuance of junk bonds, the cash flow required to service the debt normally prevents most small businesses from using this financing. For this reason, the vast majority of small businesses obtain expansion funding from issuance of common stock, preferred stock or mezzanine financing instruments.

Rated Debt is debt that has been rated by rating agencies such as Standard & Poor’s, Moody’s or Duff & Phelps. Rated debt is issued with an investment or non-investment grade rating that is determined by the rating agency after comprehensive and stringent reviews of a corporation’s operations, capital structure, management, financial condition, and results of operations. An investment grade rating is important because some institutional investors are limited to investing in investment grade debt and, once rated, the corporation is generally able to issue rated debt with a lower coupon than that associated with non-investment grade debt. Very few small businesses reach the size and state of development necessary to issue rated debt and, accordingly, rated debt is rarely a financing option for all but the largest small businesses.

HYBRID AND OTHER FINANCING INSTRUMENTS

Leases are obligations that relate to specific assets, and are generally fixed as to rate, payment, and term. Equipment leases are a very common form of financing for most small businesses. Leases generally include some or all of the following features:

- Maintenance and other services are often built into the lease (at an additional cost);
- 100% of the asset cost, often including installation, can be financed;
- The lease terms may be longer and more flexible than other types of financing;
- The tax deduction for the lease payment may be greater than the depreciation deduction if the asset was purchased;
- The total costs over the life of the lease are usually higher than bank borrowings; and
• Cancellation or upgrade options may be available when the asset being financed is associated with a rapidly changing technology.

Warrants are securities that give holders the right, but not the obligation, to buy shares of common or preferred stock directly from a company at a fixed price for a given period of time. Each time a warrant is exercised, the number of shares outstanding increases.

Each warrant specifies:
• The number of shares of stock the holder can buy;
• The exercise price;
• The first exercise date;
• The duration of the exercise period, usually from two to five years; and
• Whether it is separately issued or attached to the bonds or notes to prevent separate sale of the warrant.

Securitizations refer to the process of pooling accounts receivable to convert the income streams from the receivables into debt securities. The income streams from the receivables provide the cash flow necessary to repay the debt. The primary advantage of securitizations is the borrower’s ability to obtain a lower interest rate because the cash flow from the securitized assets may represent a better or more ascertainable risk than that associated with the borrower’s overall operations. As the securitization market grew in the late 1990’s, a number of small businesses were successful in securitizing receivables from:
• Automobile loans;
• Leases;
• Mortgages; and
• Credit card transactions.

While this market has recently experienced a downturn, a small business generating a consistent flow of receivables from these or similar transactions should consider the securitization market when evaluating financing alternatives.

Simply put, a securitization transaction is structured as follows. The receivables are assigned by the corporation to a special purpose entity or a trust in exchange for the proceeds of the securitization, net of legal, accounting, rating and financing expenses. The receivables are generally divided into three or more tranches, with the “A” tranche having the highest advance rate due to the payment history and creditworthiness of the purchaser of the automobile or underlying asset. The advance rates for the “B” and “C” tranches are decreased to reflect the higher risk of the receivables in these tranches. The “A” tranche normally comprises 80% or more of the receivables, with the “B” and “C” tranches making up the remainder. The securitized receivables are gener-
ally rated by one of the debt rating agencies, thus necessitating a detailed review of the corporation’s credit extension policies, collateral protection practices, results of operations, and collection practices. Securitizations often carry credit enhancements that are required by investors or rating agencies, such as:

- Guarantees by the corporation;
- Insurance policies issued by third parties; or
- Obligations of the corporation to substitute performing receivables for non-performing receivables.

The securitized receivables that are collateral for the debt are identified and segregated on the records of the borrower and the corporation generally acts as servicing agent in the collection and remittance of the proceeds of the receivables to the investor that purchased the trust certificates.

*Industrial Revenue Bonds (IRBs)* are issued by a state or local government agency to finance industrial or commercial projects that serve a public good. IRBs are most often available in areas of high unemployment or enterprise zones, and to manufacturing companies that can demonstrate that their expansion will result in an increase in employment in the area of the project. In general, IRBs can be issued by the government agency to finance the entire cost of construction of a new facility for the corporation. The bonds are generally collateralized by the real estate and facility and, in some cases, a credit enhancement in the form of a stand-by letter of credit issued by a bank. IRBs are repaid through bond payments amortized similarly to a first mortgage and made by the corporation to the governmental agency that issued the bonds. IRBs are an attractive financing mechanism for small businesses where available because they are tax exempt and therefore carry a below market interest rate.

*Payment in Kind (PIK) securities* are utilized when the corporation does not have sufficient cash flow to pay interest on convertible notes or dividends on preferred stock and is seeking to retain its cash flow to the maximum extent to fund operations. If the corporation has issued a note or debenture, the PIK feature will cause the interest that is payable to be added each year to the principal amount of the note or debenture or, in some cases, to be issued in common stock of the corporation. If the corporation has issued dividend bearing preferred stock, the dividends are added to the par value and/or liquidation preference of the preferred stock on each respective payment date. As the dividends continue to accrue, the number of shares of preferred stock (or the number of shares of common stock, if the preferred stock is convertible into common stock) to be issued will increase. The PIK feature may be limited in time if, for example, the corporation has the right to issue PIK securities for the first two years in lieu of paying interest on a note, but is thereafter obligated to pay interest in cash. For the small business with cash constraints, the ability to pay interest or dividends through
issuance of a PIK security can be an attractive mechanism to maximize cash flow, but must be measured against the dilution that will occur.

THE STAGE OF DEVELOPMENT OF THE SMALL BUSINESS
DICTATES NEEDS AND OBJECTIVES OF FUNDING AND, IN
GENERAL, THE SOURCES AVAILABLE TO IT

As a small business grows and matures, its funding objectives and needs will evolve. This process also results in changes in the financing sources available to the small business. In general, the more mass the small business achieves, the wider its choice of financing alternatives and the greater the number of financing sources that can be accessed. This diversity usually results in a decrease in the overall cost of capital and contributes to the bottom line as the small business recognizes some benefit from achieving critical mass.

Table 1.1, The Funding of the Corporate Life Cycle table, sets forth four stages of development in the life of a small business and describes the typical sources of equity and debt financing available to the small business at each stage. References are provided to the financial instruments that may be issued by the small business at each stage of development on receipt of equity or debt financing.

<table>
<thead>
<tr>
<th>Stage</th>
<th>Funding Needs and Objectives</th>
<th>Equity Financing Sources/Equity Instruments Used</th>
<th>Debt Financing Sources</th>
<th>Debt Financing Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Development</td>
<td>Raise sufficient capital to complete research and development; establish infrastructure; limit dilution to founders; limit “out-of-pocket” costs of financing to maximize available resources</td>
<td>Founders, friends and family, “angel” investors, venture capital firms, and private equity groups</td>
<td>Founders, friends and family</td>
<td>Promissory notes</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Common stock and principally convertible preferred stock, options, warrants and PIK securities</td>
<td>SBA-guaranteed loans</td>
<td>SBA-guaranteed revolver or term note</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Equipment vendors</td>
<td>leases</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Hard money lenders</td>
<td>Promissory notes with high interest and collateralized by personal assets</td>
</tr>
</tbody>
</table>

(continued)
Table 1.1 **Funding of the Corporate Life Cycle*** (cont’d)

<table>
<thead>
<tr>
<th>Stage</th>
<th>Funding Needs and Objectives</th>
<th>Equity Financing Sources/Equity Instruments Used</th>
<th>Debt Financing Sources</th>
<th>Debt Financing Instruments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating</td>
<td>Sustain growth and fund strategic plans for expansion; expand infrastructure; cash flow increases may permit financing with higher out-of-pocket costs and lesser dilution; greater access to institutional sources of capital</td>
<td>All of above, retail private placements, institutional investors, public offerings and strategic partners</td>
<td>Banks</td>
<td>Revolvers</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Institutional investors and private equity convertible groups</td>
<td>Mezzanine facility, debentures or securitizations</td>
</tr>
<tr>
<td>Mature</td>
<td>Lower rates of growth and available cash flows limit need for outside capital; mergers and acquisitions may add complementary business lines; capital structure may be simplified as convertible instruments are converted and warrants are exercised; founders interest diluted as a result of prior financings; professional management may be brought in</td>
<td>Public offerings, retail private placements, institutional investors, and strategic partners</td>
<td>Banks</td>
<td>Revolvers, term notes</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Institutional investors and public offerings</td>
<td>Mezzanine facility, securitizations, high yield debt</td>
</tr>
<tr>
<td>Liquidity</td>
<td>Founders, management and</td>
<td>Public offerings, private equity</td>
<td>Banks</td>
<td>Revolvers, term notes</td>
</tr>
</tbody>
</table>
Chapter 1: Identifying Financing Options

Table Note. First, it should be noted that the alternative types of financings described in Table 1.1 are generally those available to the small business at various stages of development. As such, a small business experiencing more rapid growth may be able to obtain capital from a wider variety of financing sources earlier, while a small business with a slower growth curve may have greater difficulty in securing financing usually available at its stage of development. Second, as the small business matures, the instruments issued by it tend to gravitate to common stock, institutional placements of equity and debt, and bank financing as the small business reduces its reliance on preferred stock, warrants, mezzanine financing, and convertible instruments that generally carry a higher cost of capital.

**Summary**

When viewed through the prism of the corporate life cycle, the financing alternatives available for small businesses are more easily understood and fall into a logical sequence. Equity alternatives are dominated by common stock and preferred stock, the attributes of which can be varied significantly depending on the investor as well as the nature and terms of the financing. Credit facilities can be sourced from senior bank lenders, venture and private equity funds, commercial lenders, institutional investors and strategic partners. A number of hybrid and other financing instruments can also be used by small businesses including leases, warrants, securitizations, bonds, and PIK securities. When considering these alternatives, the management team must consider the funding needs of the corporation, the objectives to be accomplished using the financing, and the tradeoffs of cost and timing that are often present when comparing alternative forms of financing.

* * * * *
**CASE STUDY: CLIENT MEETING PREPARATION**

A client has requested a meeting to go over the financial options available to it as its business continues to grow and expansion seems a likely possibility. They want to get to "the next level" but feel overwhelmed by financial details outside their current comfort zone. They need your assistance in devising a plan and researching their options. Here are some common questions and scenarios derived from the Chapter reading. How would you respond?

**Situational Analysis**

1. The management team of the corporation in the operating stage is more concerned with having their ownership stake diluted than with the cost of financing. What alternatives would you recommend to this small business? Why?

   **Practitioner Response:** The small business would be best off seeking a bank revolver, lease financing, term debt, securitizations, and mezzanine financing than any type of equity financing. This is due to the fact either limited or no dilution would occur in management’s ownership stake. If additional debt financing is not available due to pre-existing debt, a public offering would result in the smallest amount of dilution in an equity financing.

2. What types of instruments should a small business expect an institutional investor to want to utilize if it intends to provide the corporation with debt financing? Which of these instruments would be more desirable from the corporation’s point of view?

   **Practitioner Response:** Most institutional investors will want to use instruments that clearly establish the priority of the institution ahead of equity investors and secure some equity equivalent rights such as the right to nominate a board member or observer, right to approve significant acquisitions or dispositions, dividends, distributions, and the like. Mezzanine loans, convertible debentures, and term notes could be expected, together with ancillary agreements such as financing statements, security agreements, warrants, agreements that define the “equity-equivalent” rights of the debt holder, employment agreements for the key management team members, rights of first refusal to provide additional debt, and subordination agreements with respect to senior debt. Assuming the convertible debt permitted 100% conversion, a mezzanine financing with accompanying warrants would be more favorable to the corporation because the dilution from exercise of warrants should be less than a full conversion. Of course, a term loan without warrants would not be dilutive and, therefore, most preferred, but cannot be obtained from most sophisticated institutions.
3. When considering senior debt, what are the most important terms that the bank will be focused on addressing? When is senior debt the most desirable financing alternative?

**Practitioner Response:** Banks will principally focus on the collateral base and its relative liquidity, advance rates and limitations, financial covenants, events of default, and opinions. Other important issues may include environmental issues, representations and warranties, and information or reporting requirements. Senior debt is almost always the most desirable financing alternative due to its generally lower cost, time to secure, and lack of dilution to the stockholders.

4. What are “equity claw-backs” and “rachet” clauses used for in financing documents?

**Practitioner Response:** Equity claw-backs and rachet clauses are used to adjust the corporation's relative ownership percentages of the management team and outside investors based on pre-existing performance criteria. Claw-backs facilitate the management team increasing its ownership if the corporation meets designated financial targets, while rachet clauses perform the same function for outside investors when the corporation does not meet the financial targets. These financial targets are almost always going to be different since the management team will be given incentive to attain peak performance, while the outside investors will have the opportunity to increase their ownership in “worst case” scenarios.

5. What are the differences between “tag-along” rights and “drag-along” rights? What party exercises such rights?

**Practitioner Response:** Tag-along rights are exercisable by an outside investor to “tag-along” in a sale of equity by the management team or founders of a corporation to a third party. These rights would usually require that in a sale of equity by the management or founders, the investor would be able to “tag-along” in a proportionate amount to the investor's ownership of the corporation or perhaps in an amount proportionate to the investor's ownership versus the ownership of the selling stockholders. Management may also get tag-along rights in situations where an investor arranges to sell part of its stake to a third party. Drag-along rights generally allow the corporation to “drag-along” the outside investor in a proposed sale of equity by the corporation, management or the founders, all or some of whom might be vested with the right to exercise the “drag-along.”
When faced with a multitude of financing options and a need for capital, the management of a small business will generally rely on their prior financing experience and consult with other decision-makers in order to determine the preferred course of action. While some small businesses have the luxury of planning ahead for their capital requirements, too often the "need for speed" is such that the decision making process becomes truncated as the press of business inhibits good strategic planning. This discussion is intended to arm small business management and their advisors with knowledge of the issues they may encounter in various types of financings and stages of development. Obviously, the likelihood of closing increases as the small business targets its efforts on specific financing options that are more suitable to its current stage of development.

Understanding the timetable associated with different financings and being familiar with the roadblocks that may cause delays in funding can provide the small business with a planning advantage. Although unforeseen developments always have the potential to postpone a closing, it is important that management enter the financing process with reasonable expectations concerning timing and be familiar with what events will need to occur before a closing becomes reality. The cardinal rule, if indeed one exists, is that "surprises" or delays are the last thing anyone wants in the course of negotiating and closing a financing. This discussion provides a compendium of issues that are more likely than not to surface in the financing process and guidance regarding how to plan and develop responses.
The CPA’s Guide to Small Business Financing

AN OVERVIEW: ADVANTAGES OF DEBT VERSUS EQUITY

- A debtor has no direct claim on the future earnings of the corporation. The lender is only entitled to the repayment of the principal and the agreed-upon interest charges.
- Interest on debt can be deducted on the corporation’s tax returns which in effect lowers the real cost to the corporation.
- Debt does not dilute the stockholders’ interests since the lender has no claim to the equity of the business.
- Interest and principal payments are generally a known amount that can be forecast. However, this may not be true to some extent due to the use of loans with variable interest rates that change with the market.

DISADVANTAGES OF DEBT VERSUS EQUITY

- Interest is a fixed cost that raises a corporation’s break-even point. Corporations that are too highly leveraged often find it difficult to remain profitable enough to fund additional growth.
- Cash flow is required for both principal and interest payments and such payments must be planned for.
- Debt is not permanent capital because at some point it must be repaid.
- Debt instruments may include restrictive covenants which limit management’s future actions with regard to financing and managing the company.
- A business is limited as to the amount of debt it can carry. The larger the corporation’s debt-to-equity ratio, the more risky the corporation is considered to be and the less a creditor will be willing to lend.

DEVELOPMENT STAGE FUNDING: EQUITY AND DEBT ALTERNATIVES

Equity Financing Options

In the development or early stage of the corporate life cycle, equity financing is often the only financing vehicle open to the corporation. The corporation usually lacks sufficient assets or cash flow to obtain debt financing except in isolated instances. Equity investors at this stage are generally comprised of:

- Founders of the corporation;
- “Friends and family;”
- Angel investors;
- Venture capital firms; and
Chapter 2: Alternative Financings

• Private equity groups.

The founders and friends and family will generally purchase common stock and may receive options or warrants for services rendered or, perhaps, as a "kicker" for being an early stage investor. The terms of the investment are generally described in subscription documents that may be accompanied by a copy of the business plan.

Angel investors are typically high net worth individuals who invest in early stage enterprises with a view toward generating high rates of return not available in later stage investments. Angel investors are often entrepreneurs who have an interest in supporting early stage businesses and may serve as informal mentors or seek a seat on the board of directors.

Angel investors do not generally purchase debt instruments due to the fact that the returns are limited and, unless they receive warrants to purchase common stock with the debt instrument, their interest is in holding common stock with no limit in possible upside appreciation. Most angel investors will invest through a purchase of common stock that might be priced at a level higher than the founders but below that paid by an institutional investor. In some cases, angel investors may seek to invest alongside an institutional investor to ameliorate, to some degree, the element of risk associated with an earlier stage investment. More sophisticated angel investors that invest larger sums may seek to purchase preferred stock with the protections and investment terms normally sought by venture capital firms and private equity groups. Angel investors may invest anywhere from $10,000 to $2 million or more. Depending on the amount invested, angel investments may be documented by a subscription agreement accompanied by a business plan or a term sheet followed by a purchase agreement.

Venture capital firms and private equity groups are generally the largest cash investors in early stage entities. Venture investors have established:

• Minimum and maximum investment amounts;
• Areas of concentration within specific industries or markets;
• Investment horizons of five to seven years to a liquidity event;
  Annualized rate of return benchmarks that range from 35% to 40% or more; and
• Policies concerning their participation on the board of directors, board committees, assistance in planning, recruiting of management personnel and mechanisms to increase their control over the business if financial goals are not realized.

Most venture firms have minimum investments of $100,000 to $4 million and maximum investments ranging from $250,000 to $50 million.

A number of venture investment firms are organized as Small Business Investment Companies (SBICs). SBICs are licensed by the SBA
but are privately owned and managed firms that make their own investment decisions. Once licensed, an SBIC is eligible to receive long-term, low interest loans from the SBA that mature in five to 20 years from funding. In general, the SBIC is eligible to receive loans that are two to three times the amount of the equity of the SBIC. While SBICs may invest in start-up and early stage enterprises, SBICs are restricted from investing in:

- Non-manufacturing companies with a net worth in excess of $6 million or average net income after taxes for the preceding two years of over $2 million;
- Manufacturing companies with more than 250 employees unless the company meets the net worth or net income tests described above; and
- Other investment companies or lending institutions.

Private equity groups are usually organized as hedge funds or other forms of pooled investment capital that are capitalized by pension funds, money management firms, other institutions and select high net worth investors. Private equity groups can be broken down into three types:

- Early stage investors similar to venture funds;
- Operating and mature stage investors; and
- Buy-out groups oriented to mature company investments, financing of management-led buyouts and leveraged “recaps.”

Leveraged recaps are transactions similar to management-led buyouts in structure, but rather than increasing their ownership stake, the founders reduce their ownership and receive cash that is funded by borrowings from financial institutions or the private equity group, or both. The private equity group provides the equity investment that, to a greater or lesser degree, replaces the equity cashed out by the founders and that is necessary to meet the minimum equity investment required by debt financing sources. Private equity groups are well suited to provide financing to:

- Family owned businesses or holders of concentrated ownership positions in private companies;
- Funding of ESOP and employee-led buyouts of retiring management;
- Management-led buyouts; and
- Start-up and early stage companies with some infrastructure, a strong management team and good business fundamentals.

**Typical Preferred Stock Terms for Issuances to Venture and Private Equity Investors**

The typical venture or private equity investor does not usually purchase common stock or, if common stock is purchased, the common stock will be a small percentage of the overall investment. While institutional investors
may differ in investment details, the profile of an early stage investment in preferred stock by a venture or private equity firm will usually have the following attributes:

- Convertible into common stock to provide liquidity if a public market develops for the common stock;
- Conversion will be optional at the holder’s election, and mandatory on completion of IPO or sale of the corporation;
- Mandatory redemption terms if a liquidity event does not occur within specified time frames; redemption will generally be within the last few years of the time frame for the holder’s investment; may include a redemption premium over and above the stated liquidation value of the preferred stock which operates as a “penalty” for failure to achieve a liquidity event;
- May be accompanied by warrants to purchase common stock, depending on how valuation issues are resolved;
- Features anti-dilution for specified events (stock splits, dividends, mergers) and price anti-dilution that becomes effective if the corporation sells common stock below the conversion price of the preferred stock;
- Cumulative dividends that are payable in PIK securities or become part of the preferred stock’s liquidation preference;
- Liquidation preferences that assure the preferred stock purchaser receives the stated amount in the event of liquidation prior to any distribution to holders of common stock; the liquidation preference may have a “ratchet” clause that triggers automatic increases in the liquidation preference if the corporation has not redeemed the preferred stock, or it has not been converted, by specified dates during the life of the investment;
- The preferred stock will vote on an “as converted” basis on all matters voted on by the common stockholders;
- Holders of the preferred stock will have the right to vote upon and approve or disapprove certain matters including acquisitions, change of control transactions, issuance of new series of preferred stock, modifications in the rights and preferences of the preferred stock, changes in use of proceeds of the financing, changes in the nature of the corporation’s business, changes in the number of directors (unless pursuant to the rights of the holders of preferred stock to increase their representation on the board of directors if the corporation fails to meet certain performance benchmarks), transactions with insiders not approved by the disinterested board members, changes in compensation for executive officers, issuance of options or warrants in excess of predetermined amounts, and any modifications in the corporation’s governing charter documents;
- Rights of first refusal or preemptive rights to purchase securities sold by the corporation in subsequent financings, subject to standard exceptions for issuances to strategic partners;
• Standard tag-along and drag-along rights and, in some cases, an equity claw-back for the benefit of the senior management;
• Registration rights for common stock issued on conversion, including demand and piggyback rights, with all expenses paid by the corporation;
• Provisions regarding board representation, financial reporting, budget review, operational status, inspection rights, key man life insurance, and continuity of management;
• Payment of all legal fees for the purchasers of the preferred stock;
• Designation of the investor’s counsel as having the primary drafting responsibility for the purchase agreement and ancillary documents; and
• A “sunset” provision that states that certain rights of the holders of the preferred stock expire automatically on completion of an IPO.

Preferred stock investment terms are initially set forth in a term sheet prepared by the venture or private equity investor. Once agreement is reached, the parties may execute a version of the term sheet or may instead execute a letter of intent that embodies the terms initially described in the term sheet.

Practice Tip. Appendix A, “Sample Term Sheet for Preferred Stock Purchase by Venture or Private Equity Investor,” is based on an actual venture financing received by an early stage company. This form is typical of term sheets used by venture capital and private equity firms. Reviewing this term sheet will help you understand how the prospective investor describes the typical terms of a venture or private equity investment. Notice that many of those terms were introduced in Chapter 1, “Identifying Financing Options Available to Growing Small Businesses.”

Occasionally an “IPO window” opens that permits an “early” public offering by a corporation during the development stage. The most recent example of the availability of this type of financing was the enormous increase in early public offerings by “dot com” companies that occurred in 1998 and 1999. Small businesses should recognize this phenomenon for what it is: a speculative bubble that inevitably disappears as valuations return to more traditional models. This does not mean a small business should disregard opportunities for financing created by market forces, but the availability of an IPO window is something that cannot be planned for. The early public offering is covered in detail under the discussion relating to operating stage equity financings found later in this Chapter.

Table 2.1, “Business Considerations for Equity Financing,” sets forth the relative advantages and disadvantages of the most common forms of early stage equity financing. As the table indicates, there is to some extent a trade-off between speed and availability of funding. When comparing funding from institutional investors to that provided by founders, family,
friends, and angel investors, the key differences relate to issues concerning control, valuation and restrictions on future operations and funding that are usually not the subject of negotiations with angel investors and affiliates.

Table 2.1 Business Considerations for Equity Financing

<table>
<thead>
<tr>
<th>Common Sources of Early Stage Equity Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders, friends and family</td>
<td>Speed; simplicity of documentation</td>
<td>Limited funds availability</td>
</tr>
<tr>
<td>Angel investors</td>
<td>Funding availability; generally simple documents; valuation more favorable than institutional investor</td>
<td>Time to identify; funding amount per investor may be limited; structure may be variable, requiring more documentation</td>
</tr>
<tr>
<td>Venture firms and private equity groups</td>
<td>Availability of capital</td>
<td>Control issues; valuation reflects risk profile and necessary high rates of return; complex documentation; higher expenses; restrictions on future operations and funding</td>
</tr>
</tbody>
</table>

DEBT FINANCING OPTIONS

Debt financing available in the development stage is severely limited due to the corporation’s inability to service the debt from cash flow. Investors that help finance early stage entities are acutely aware of these limitations and the need to preserve cash flow for operating activities, with the result that nearly all early stage investors will seek rates of return that can only be provided through equity. There are, however, a limited number of debt financing options open to the development stage entity: loans from founders, family and friends, or “affiliates;” SBA-guaranteed loans; lease financing provided by equipment vendors; and “hard money” loans.

Advances from affiliates are often provided to meet working capital needs of the development stage corporation. These advances are sometimes non-interest bearing or pay interest using a PIK security, are frequently due on demand, and are accompanied by warrants or options that allow the affiliate to purchase common stock at a nominal exercise price. Perhaps the most common issue that arises in these situations is determining if the founders and other affiliates will merely purchase additional common stock or make funds available to the corporation in the form of a loan.
Unless all founders are equal participants in providing the debt funding, or there is only one founder from whom the funds will be received, the use of promissory notes to document all or a portion of the financing can offer several benefits:

- In the event the stock ownership of the founders was previously negotiated and the purchase of additional stock would cause disagreements among the founders, the use of loans can facilitate the receipt of capital without having a direct or immediate impact on ownership percentages;
- Loans from affiliates at this stage of development may be secured by a first lien on substantially all of the corporation's assets due to the absence of other debt;
- If the corporation has sold, or is selling, common stock to non-affiliates at a price per share that is higher than the price per share payable by affiliates if they purchased stock, a loan transaction facilitates funding without raising tax or disclosure issues related to the sale of stock at less than fair market value;
- If the founders would like to obtain an early return of a portion of their "investment" in the corporation, it may be possible for the founders to predicate the next round of financing from venture or private equity firms on the repayment of loans received from affiliates; and
- Should the corporation begin to generate cash flow such that bank debt can be obtained, the bank may be willing to fund the repayment of affiliate loans if the affiliate provides a personal guarantee to the bank.

As discussed in Chapter 1, "Identifying Financing Options Available to Growing Small Businesses," the most common form of SBA debt financing is the SBA guaranteed loan. These loans are limited in amount and are often available only to start-ups or early stage businesses that are not eligible for other types of debt financing. Where available to the small business, SBA guaranteed loans are quite advantageous due to their low interest rates that reflect the credit enhancement offered by the SBA. If SBA guarantees are not available, the small business must look to equity financing or, in the unlikely event other debt financing was obtainable, such debt financing would undoubtedly require affiliate guarantees and/or equity "kickers" such as warrants or options to purchase stock.

The restrictions on SBA direct loans discussed in Chapter 1, "Identifying Financing Options Available to Growing Small Businesses," are such that these types of loans are unavailable to the vast majority of small businesses. Since the corporation must be turned down for an SBA guaranteed loan as a condition for being considered for an SBA direct loan, and the amount of the loan cannot exceed $150,000, only the smallest businesses and start-ups will meet the lending criteria for SBA direct loans. Again, while the terms of these loans are very advantageous to the small
business borrower, the extremely limited availability of SBA direct loans means that these loans cannot be counted on to meet the financing needs of most small businesses.

*Lease financing* is generally provided by captive finance subsidiaries of equipment vendors or specialty finance companies that provide such financing for equipment vendors. Although lease financing generally has a higher cost than bank financing, lease financing may be available for a broader range of equipment and for early stage companies that would not otherwise qualify for bank financing. For example, while banks may be reluctant to make loans for the purpose of acquiring special purpose equipment such as medical diagnostic imaging devices, lease financing is often provided by medical equipment manufacturers so that emergency care clinics and others can obtain and install such equipment. The manufacturer has a vested interest in increasing its installed base of equipment for the purpose of soliciting sales of ancillary, add-on or new generations of its equipment and obtaining revenues from service contracts and sales of supplies. For these reasons, the vendor is usually more willing to assume a financing risk in connection with the lease transaction. The vendor is also typically in a position that should repossession of the equipment become necessary, the vendor has contacts among its other customers that make the resale, or re-lease, of the equipment much more likely. In those instances where lease financing is provided by outside specialty finance companies, these companies often have arrangements with the equipment manufacturer under which the manufacturer will repurchase the equipment for set prices during all or a portion of the term of the lease if repossession becomes necessary. Since lease financing is based primarily on the collateral value of the equipment, the small business may be less likely to need the founders to provide personal guarantees. Conversely, if personal guarantees are necessary, the founders may only be liable for any deficiency that results from the sale or re-lease of the equipment. Banks do not generally have such arrangements and, for that reason, may be reluctant to provide loans for the purchase of equipment that is not readily salable. Banks are also more concerned with cash flow generated by assets and may not be as willing to assume significant utilization rates as vendors or specialty finance companies. When combined, these factors mean that lease financing arrangements may facilitate the acquisition of equipment that might otherwise be difficult to finance using a bank.

The final source of debt financing for the development stage small business is “hard money” lenders. These lenders are normally comprised of:

• Bridge capital lenders;
• Groups of angel investors;
• Unregulated specialty finance companies; and
• Small private equity investors.
Hard money lenders engage in *highly risky* lending transactions. The hard money lender generally charges interest rates of 20% to 35% per annum, which is permissible in some states as long as the interest is charged in a business transaction, rather than a consumer transaction. Hard money lenders often have a first security interest in all assets of the business and will frequently obtain personal guarantees of the founders, liens on the founders’ residences or pledges of specific collateral outside of the business as additional security for the repayment of the loan. The corporation is also required to pay the legal fees of the lender to document the transaction and is usually charged up-front facility fees that increase the cost of the financing above the stated interest rate. As might be expected from their name, hard money lenders offer the most expensive debt financing a business can secure and may expose the founders or management to a significant risk of loss of their personal assets. Hard money lenders should be considered the avenue of last resort for debt financing of the small business. Moreover, the founders and management should carefully consider the implications of the corporation’s inability to obtain financing from sales of equity or sources other than hard money lenders. It may be the perception of investors and more established credit providers that the business lacks some fundamental element, such as a market for its products or services, management experience, or the financial wherewithal to withstand changing market conditions. If so, the founders and management may wish to consider the message this sends about the perceived chances of the corporation’s success prior to putting their personal assets at risk by collateralizing a hard money loan.

Table 2.2, “Business Considerations for Early Stage Debt Financing,” includes the relative advantages and disadvantages of the most common forms of early stage debt financing. As is the case with equity financing, the principal advantages and disadvantages revolve around the cost and speed of the financing, although collateral issues add another dimension that must be considered in the analysis.

**Table 2.2 Business Considerations for Early Stage Debt Financing**

<table>
<thead>
<tr>
<th>Common Sources of Early Stage Debt Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders, friends and family</td>
<td>Speed; simplicity of documentation; ability to fund when equity offering is on-going; repayment often earlier than when proceeds received from equity sales</td>
<td>Limited funds; dilution from any equity kicker; possibility of ownership changes on conversion</td>
</tr>
</tbody>
</table>
Common Sources of Early Stage Debt Financing

<table>
<thead>
<tr>
<th></th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>SBA-guaranteed loans</td>
<td>Low cost; no equity kickers; relatively low exposure on personal guarantees</td>
<td>Time to secure; conditions to qualify; limits on loan amount</td>
</tr>
<tr>
<td>Equipment vendors/lease financing</td>
<td>Generally fast; equipment is primary collateral; expenses low</td>
<td>Higher cost than bank debt; may be limited to certain types of equipment; may require supply or service contracts</td>
</tr>
<tr>
<td>Hard money lenders</td>
<td>Funds availability when other sources are tapped out</td>
<td>Cost; exposure on guarantees and personal assets; higher expenses to close</td>
</tr>
</tbody>
</table>

Operating Stage Funding: Equity and Debt Alternatives

In the operating stage, the corporation is often blessed with a much wider variety of financing options than previously available. This blessing, however, can be mixed. The simplicity of decision making that characterized early stage financing is suddenly made much more complex as a result of new factors that must be considered that are not readily quantifiable or easily ascertained. The factors that require evaluation may include:

- Positive and negative aspects of financing the business through widely distributed securities (*i.e.*, a private placement to retail investors) or through securing one or two large, institutional investors;
- Positive and negative aspects of establishing a financing relationship with potential strategic partners;
- Comparison of the cost of capital under significantly different instruments that do not permit across the board comparisons, such as the cost of warrants or preferred stock;
- Consideration of market conditions and their impact on an operating stage public offering; and
- Review of valuation, control and cost issues associated with equity financings versus the limited availability and personal exposure that may come with debt financing.

Financing choices in the operating stage cannot often be distilled down to the *right* choice; rather, the corporation is faced with making a determination of which financing option has more *apparent* benefit than others.
The choice of one financing option over another may in retrospect appear less desirable due to changes in:

- Market or economic conditions;
- Management;
- Relationships with financial institutions, investors or strategic partners; and
- Factors that affect the business that are outside of the corporation’s control.

**Practice Tip.** Given the uncertainty inherent in the choice of the “right” financing option, most small businesses are often best served by simultaneously proceeding down several alternative paths to the extent possible and maintaining a backup plan that can be activated if a particular type of financing becomes unavailable for any reason. The simultaneous exploration of several options is not difficult given the fact that the same business plan, with minor modifications, can be used to initiate discussions with both equity and debt financing sources.

**Equity Financing Options**

The operating stage business is generally able to secure equity financing from the investors identified in the development stage and four additional sources:

- “Retail” private placements;
- Institutional investors;
- Public offerings; and
- Strategic partners.

A “retail” private placement, as opposed to a placement of securities with one or a small number of institutional investors (discussed below), is best described as the sale of equity securities to individual investors. A retail private placement may be conducted by the corporation, in which event the officers and directors sell the equity securities to friends, family and associates. This is referred to as a “self-underwritten” placement. The federal securities laws permit officers, directors and employees of the corporation to sell securities without being a registered broker-dealer so long as such persons are not paid commissions or other compensation that is based on the sales of securities. Most states have similar exemptions for sales made by officers and directors. Some retail private placements are hybrids that permit the corporation to sell securities through the officers and directors on a self-underwritten basis, but also provide for the payment of commissions to investment banking firms that solicit purchasers who invest in the placement.

A retail private placement, or private offering, may also be sold by an investment banking firm. If so, the investment banker will almost always solicit retail investors on a “best efforts” basis. In other words, the offering
will not be made by the investment banking firm on a “firm commitment” basis, which is by far the predominant form of public offering that is underwritten by investment bankers. There are two types of best efforts offerings, the “all-or-none” and the “mini-maxi.” If the placement is structured as a “best efforts, all-or-none” sale of securities and the amount of the offering is $2 million, the investment banker will use its best efforts to solicit purchases of equity totaling $2 million. If the offering period expires and there is less than $2 million in the escrow account, the money must be refunded to the intended purchasers according to the rules and regulations of NASD Regulation, Inc., the regulatory arm of the National Association of Securities Dealers that governs the activities of investment banking firms. If the balance of the escrow account has reached $2 million, a closing is held and the proceeds, less commissions and expense allowances payable to the investment banker, are delivered to the corporation.

Using the example above, if the investment banker and the company determine to structure the placement as a “mini-maxi,” the placement might be described as a $1 million mini, $2 million maxi. In this event, if the balance of the escrow account exceeds $1 million, an interim closing may be held and the offering will continue until the earlier of (i) expiration of the offering period, or (ii) the date on which the full $2 million is subscribed for. The advantages of a mini-maxi are obvious:

- If the sales effort falls short, the corporation will still receive capital, albeit that the proceeds may be less than the desired amount;
- If the sales effort is successful, the corporation will still be in a position to receive the full $2 million; and
- The corporation and/or the investment banker may continue the selling effort after the initial closing, secure in the knowledge that the expenses of the offering such as legal, accounting, printing and “roadshow” costs have been covered.

A retail private placement may be structured using a relatively small amount such as $10,000 as the minimum investment or may be structured for minimum investments of $50,000 or $100,000 per investor. At the lower amount, the placement would in all likelihood be sold to both accredited and non-accredited investors. At the high end, the offering would be structured as one for sale only to accredited investors. The distinction between accredited and non-accredited investors is very important when the corporation, its investment banker (if any) and counsel are determining:

- What exemptions under federal and state securities laws will be relied upon for purposes of making sales of the securities;
- What form of selling document will be used; and
- Whether audited or unaudited financial statements must be used in the offering document.
These issues are discussed in detail in Chapter 6, “Deal Breaker Issues,” and Chapter 7, “Documenting the Financing Through Closing,” but are mentioned here to highlight the impact of securities laws, rules, and regulations on the typical retail private placement.

Institutional investors rarely consider investments in development stage entities but will sometimes invest in an operating stage company. Broadly defined, institutional investors may be:

- “Second stage” venture investors;
- Private equity groups that fund expansion;
- Funds and investment advisors that specialize in small-cap companies; and
- Pooled investment funds managed by associated angel investors.

The institutional investor that is willing to purchase equity securities in an operating stage private company is relatively uncommon. While investors within the categories listed above will occasionally make equity investments, it is much more common for these investors to purchase debt securities that are convertible to equity or are accompanied by warrants. Much like the early stage venture investor, institutional investors are more likely to demand far too much of the corporation’s ownership, and to offer much too low a valuation, in conjunction with equity investments in operating stage entities. If equity is purchased, it will most likely be in the form of preferred stock with attributes similar to those of preferred stock issued to first round venture investors.

A public offering for the operating stage entity is an option that merits consideration if market conditions are receptive to initial public offerings. At this stage of the corporate life cycle, public offerings are usually small (from $5 million to $15 million) and are commonly referred to as “public venture capital.” This description is apropos, especially when one considers the failure rates of small businesses that go public at this stage. Nonetheless, if a company is engaged in operations in an industry that the market has identified as desirable, the valuation that the operating stage corporation will receive will be far in excess of the valuation offered by any other equity investor. This must be balanced, to some degree, against the fact that the corporation may expend a significant amount in pursuing a public offering with no assurance that the offering will be completed due to deteriorating market conditions or other reasons.

The public offering is almost always a “firm commitment” offering. A firm commitment offering is one in which the investment banking firm contractually commits to deliver the proceeds of the offering to the corporation three days following the commencement of trading (known in the securities industry as “T+3”), and therefore has the investment banker’s capital “at risk.” Firm commitment offerings are not aptly described, for the following reasons:
• The corporation and the investment bankers operate under a letter of intent from the time the investment banker is retained until the offering is *cleared*, or "declared effective," by the SEC. The letter of intent can generally be terminated at any time by either the corporation or the investment bankers without liability (subject to limited exceptions that usually favor the investment banker);

• Once the contract, known as the *underwriting agreement*, is signed between the corporation and the investment banker at or following the time the SEC declares the offering effective, the investment banker can still refuse to close within the T+3 timeframe if there is a natural disaster, war, significant decline in the market, death of a key member of management, or other event that causes the investment banker to conclude that the offering should be terminated or rescinded (this is known as the "market out" clause); and

• The smaller investment banker generally has limited capital and, therefore, smaller public offerings are usually closed through use of a subordinated loan from the investment banker’s clearing firm that is repaid once payments for orders from individual investors are received.

As with smaller private placements, the small public offering is customarily a "retail" public offering. This means that the investment banking firm specializes in serving individual investors, rather than institutions. The “lead” investment banker in a retail public offering will often have a number of offices staffed by retail brokers and may recruit other investment banking firms to become part of the selling “syndicate.”

If the lead investment banker has very limited capital or a small clearing firm, the lead investment banker may have to proceed with the offering on a "best efforts" basis. While best efforts offerings were once popular in the small-cap market segment, nearly all small investment bankers now underwrite their offerings on a firm commitment basis. This is due to, among other things, the support of clearing brokers in bridging the funding necessary to complete the public offering and the impact of federal, state, and exchange listing regulatory requirements on best efforts offerings in particular.

Equity investments received from *strategic partners* are another financing alternative that is sometimes available for businesses in the operating stage. Strategic partners are often willing to purchase a minority ownership stake accompanied by licensed rights to technology, shared markets or a teaming approach to marketing, or guaranteed access to production of key products. These financial partnerships are "strategic" in the sense that the investor is not merely a financial investor, but is usually engaged in a business related in some fashion to that of the small business. Strategic partnerships became quite prevalent in the late 1990's among a variety of technology companies including:
• Providers of routing and switching equipment and small high speed Internet access providers;
• Telecommunications infrastructure providers and small voice and data carriers;
• Larger search engines and e-businesses offering products or services targeted at specific markets; and
• Software companies seeking to secure access to particular products such as video or sound technologies or channels for new applications.

Strategic investments take various forms but usually involve the purchase of equity in the small business for several reasons. First, the strategic investor customarily obtains a technology license or new marketing or sales channel out of the relationship and, therefore, the purchase of an equity stake allows the strategic investor to capitalize on the increase in revenue or bottom line that the small business derives from the relationship. This is particularly true if the strategic investor is a very large company whose association with the small business will validate the small business’s technology for other customers. The small business that recognizes this reality is often willing to sell an equity stake to the strategic investor, thus:

• Increasing its equity capital base;
• Validating its technology; and
• Creating a marketing campaign that promotes the relationship to attract new strategic partners and to inform the market as to how the small business will use strategic relationships to grow its business.

Strategic partners often invest through purchase of a new series of preferred stock that may offer significantly more favorable conversion terms than simultaneous issuances to financial investors, thus reflecting the non-financial benefits derived by the small business from the strategic relationship. In addition, because many small businesses in the operating stage still lack the cash flow necessary to make interest and principal payments on indebtedness outside of bank debt, the non-financial benefits received by the strategic investor such as access to new technologies or markets will often mean that a strategic investor will be more interested in the long-term return on the investment, rather than current rates of return. If the strategic investor is uncertain of the degree to which it will be able to capitalize on the relationship, or if the technology offered by the small business is not acquired under an exclusive license, the strategic investor may attempt to tie the conversion rate to sales or other targets. If the sales that the strategic investor derives from the technology fall short of expectations due to delays in implementation or customization issues, the conversion rate may “ratchet” down to a lower level, based on the failure to reach certain per-
formance benchmarks within specified time periods. Like ratchet clauses used by venture and private equity firms, a ratchet clause is a potent means of tying the performance of the small business's technology or market penetration to the resulting ownership by the strategic investor. All performance benchmarks must be carefully evaluated from a conservative viewpoint when being considered by the small business.

**Warning.** Because strategic partners have non-financial as well as financial goals, or goals that may not be reflected solely in the calculation of financial returns on the investment over a specified timeframe, the small business will usually find that an investment proposal from a strategic investor will be more advantageous to the corporation than a proposal for the same investment amount from a so-called financial investor. Therefore, the small business is well advised to evaluate potential strategic investors when seeking expansion capital, particularly if the corporation's business or technology can be partnered with existing products or services in a way that will enhance a strategic partner's financial performance or permit it to access additional markets at a lower incremental cost.

Table 2.3, "Business Considerations for Operating Stage Equity Financing," illustrates the relative advantages and disadvantages of the most common forms of operating stage equity financing. As the table indicates, the number of financing options at this stage in the corporate life cycle is considerably greater than the alternatives available to the early stage entity.

<table>
<thead>
<tr>
<th>Common Sources of Operating Stage Equity Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Founders, friends and family</td>
<td>Inexpensive; few restrictions; little documentation</td>
<td>Availability often restricted</td>
</tr>
<tr>
<td>“Angel” investors</td>
<td>No high fees; may provide loan guarantees; eager to help management make business successful; usually simple documents</td>
<td>Perhaps limited follow-on money; expect big returns; difficult to identify</td>
</tr>
<tr>
<td>Venture capital firms</td>
<td>Funding availability; prefer to invest large amounts</td>
<td>Expect big returns; expect fair amount of control; difficult to identify the right firm; extensive documentation</td>
</tr>
</tbody>
</table>

(continued)
Table 2.3 Business Considerations for Operating Stage Equity Financing (cont’d)

<table>
<thead>
<tr>
<th>Common Sources of Operating Stage Equity Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private equity groups</td>
<td>Provide funding when other sources may not; availability</td>
<td>Expect big returns; control issues; difficult to identify; extensive documentation</td>
</tr>
<tr>
<td>Private placements</td>
<td>Inexpensive; fast; exempt from federal registration</td>
<td>Limited funding; documentation required to show compliance with SEC requirements; may not be exempt from state registration; need for investment banker may increase cost</td>
</tr>
<tr>
<td>Strategic partners</td>
<td>Less expensive; promotes working together to make business grow</td>
<td>Complex documentation; possible restriction on sale of technology to others; conflicts of interest may complicate investment</td>
</tr>
<tr>
<td>Institutional investors</td>
<td>Funding availability; experience in the area</td>
<td>Expensive; complex documentation</td>
</tr>
<tr>
<td>Operating stage public offerings</td>
<td>Funding availability; high valuation</td>
<td>Accountable to new shareholders; must adhere to complex SEC regulations; relatively slow process; expensive</td>
</tr>
</tbody>
</table>

Debt Financing Options

As the small business reaches the operating stage, debt financing options become realistic alternatives to equity financings. In the case of banks and equipment vendors or leasing firms, debt financing can be very advantageous to the small business because:

- These financing sources do not demand a piece of the “equity pie;”
- Interest costs and fees associated with these types of debt are usually reasonable; and
- The expenses (legal, filing fees and other) of securing revolvers or leases are usually low.
At this stage of its development, the corporation is usually able to negotiate with local banks or local branches of larger banks for revolving credit and is not condemned to dealing with hard money lenders or friends and family to secure debt financing. Institutional investors and private equity groups will also provide mezzanine credit facilities to select small businesses in this stage, although these facilities will be coupled with warrants or conversion features that increase the rate of return for the investor, and the expense to the corporation, to a level well beyond that associated with traditional bank debt or lease financing.

Bank financing for operating stage companies is most often provided through revolvers that have most or all of the attributes described in Chapter 1, “Identifying Financing Options Available to Growing Small Businesses.” Revolvers are usually a small business’s senior credit facility and have a secured priority over all other creditors. The revolver is documented using promissory notes, credit and security agreements, or “line of credit” notes that are usually renewable on an annual basis if the small business is in compliance with financial and non-financial covenants. When associated with smaller financings, these documents may be as short as five to six pages and are therefore easy and quick to negotiate and close. As the size of the revolver increases, the complexity of the documentation will likewise increase as the bank:

- Imposes additional covenants or reporting obligations on the corporation;
- Establishes other conditions such as limitations in any changes of key management or maintenance of key man life insurance policies covering the founders; and
- Offers the corporation a choice of rate structures, such as interest calculated on the basis of the bank’s prime rate or on the basis of rates offered by major banks in the London Interbank Eurodollar Market (LIBOR).

Almost without exception, banks will seek personal guarantees from the founders and/or principal stockholders of the small business. While it is true that many founders lack sufficient assets to pay off the revolver should the corporation encounter difficulties, banks will require the guarantee often for no other reason than its in terroram value. In the case of larger revolvers, the founders may be required to execute support agreements in favor of the bank that obligate the founders to assist the lender in disposing of the collateral and to collect accounts receivable during a period that may extend for up to 12 months after the occurrence of an event of default.

Debt financing provided by institutional investors and private equity groups to operating stage companies may be denominated as debt but, as discussed earlier, will have built in conversion rights or attached warrants to increase the rate of return to an “equity equivalent” level. This type of debt financing is often described as mezzanine debt, referring to its being
“layered” in between the senior credit facility and the equity of the corporation. Mezzanine debt is subordinated in right of payment to the senior bank debt. Many mezzanine debt facilities do not require personal guarantees from the founders as the risk/return assessment performed by the investor is based on the value of the equity “kicker” as opposed to a strict analysis of the creditworthiness of the borrower such as that performed by a bank.

Author’s Note. As used in this publication, the terms “mezzanine debt” or “mezzanine financing” are not limited to the accounting definition normally associated with this type of financing. Rather, mezzanine financing refers to debt instruments that combine features of debt and equity and may be in the form of debentures, promissory notes, convertible debentures, preferred stock, and similar instruments.

Because mezzanine debt financing is commonly an “equity equivalent,” the terms of mezzanine debt are generally very similar to the terms of a preferred stock issue purchased by a venture or private equity investor. Accordingly, interest is payable in an amount comparable to preferred dividend rates and may be payable in the form of a PIK until a year or two has passed. The mezzanine purchaser will also negotiate for similar or identical rights to those below.

• Voting rights
• Conversion rights
• Anti-dilution rights
• Rights of first refusal or preemptive rights
• Registration rights
• Equity ratchet clauses
• Tag-along and drag-along rights
• Financial covenants and other restrictions
• Board representation or observer rights

See Chapter 1, “Identifying Financing Options Available to Growing Small Businesses,” for a detailed discussion of these rights. If the mezzanine debt is convertible, the purchaser will be able to exercise these rights immediately after closing on an “as-converted” basis. If the equity component of the transaction is delivered through issuance of warrants, the rights associated with the warrants will be vested through the terms of the warrant agreement or a separate rights agreement.

Mezzanine debt usually has a term of three years to as long as eight years, but requires prepayment if a sale of the business or other liquidity event occurs. If not prepaid, mezzanine debt may be vested with additional rights and/or ownership of the small business if the maturity date passes before retirement of the debt.
Some commercial finance companies offer term loans to small businesses that may be secured by receivables, inventory, or perhaps other assets. These loans may take the place of bank revolvers if the corporation has been unable to secure bank financing, and will generally carry higher fees and a higher interest rate than bank financing. These loans may also be structured as lines of credit that operate like revolvers.

Small businesses that generate accounts receivable that can be pooled and sold as debt securities can sometimes avail themselves of securitization transactions to provide a significant source of funding. Securitizations generally are in the form described in Chapter 1 and typically involve a number of outside parties such as the underwriter, investor (purchaser of the trust certificates), a rating agency, and an issuer of insurance. The underwriter is retained by the small business to identify investors, which generally are insurance companies, pension funds, and institutional investors that purchase asset-backed securities. The rating agency conducts a “top to bottom” review of the corporation’s means of generating, servicing, and collecting the accounts receivable and, in conjunction with the other parties, will determine the parameters of the different tranches of securitized receivables as a percentage of the entire financing. The insurance company issues an insurance policy that serves as a credit enhancement for the securitization, thereby providing a level of assurance to the investor and reducing the implicit interest rate paid by the corporation to the investor.

Securitizations are used by many small businesses to fund their financing requirements. These businesses are usually those that generate consistent and predictable cash flows from accounts receivable associated with mortgages, credit card transactions, equipment leases, and auto loans or leases. The small business usually funds the loan or lease transaction from a so-called “warehouse” line of credit that, once fully committed, is then repaid from the proceeds of the securitization. At closing, the small business is paid the net proceeds of the securitization from the special purpose entity or trust. The special purpose entity or trust simultaneously receives title to the receivables and the small business is retained by the special purpose entity under a servicing agreement to collect the monthly payments, foreclose and repossess collateral, and recover any deficiencies. Even though the insurance policy is put into place to protect the investor from defaults, the terms of most securitizations require the small business to substitute performing leases or loans for non-performing leases or loans in the securitized portfolio. In this fashion, the small business is incentivized to carefully monitor credit quality on an on-going basis and to maximize its rate of collection so that its newly generated receivables will be available to securitize in another transaction.

Securitizations generally carry a low cost of capital and, for those small businesses able to access the asset-backed securities markets, securitizations may be one of the most cost effective means of converting senior bank debt into low cost, longer term debt financing. This used to be particularly true when corporations were able to utilize “gain on sale” accounting that accelerated the gain from a secu-
ritization to the current period rather than recognizing gain over the life of the securitized leases or loans. Statement of Financial Accounting Standards (SFAS) No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," clarified the use of gain on sale accounting and many small businesses discontinued the use of gain on sale accounting, even when surrendering control of the financial assets, after the issuance of SFAS No. 125.

In periods of declining credit quality and poor business conditions, securitizations can be difficult to complete and the obligation to substitute performing leases or loans may significantly impact a small business's ability to generate cash flow for operations. Accordingly, corporations must carefully evaluate conditions in the asset-backed securities markets, general economic conditions, the state of the industry in which they operate, and other factors before seeking to undertake a securitization.

Table 2.4, "Business Considerations for Operating Stage Debt Financing," includes the relative advantages and disadvantages of the most common forms of operating stage debt financing.

### Table 2.4 Business Considerations for Operating Stage Debt Financing

<table>
<thead>
<tr>
<th>Common Sources of Operating Stage Debt Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>Do not dilute founder's interest; continuing availability of credit; fewer reporting responsibilities and requirements</td>
<td>Requires collateral or personal guarantees; loan agreements include restrictive covenants; interest payments; cash flow required to pay debt</td>
</tr>
<tr>
<td>Institutional investors and private equity groups</td>
<td>Availability</td>
<td>Expensive; level of documentation; cash flow required to pay debt</td>
</tr>
<tr>
<td>Equipment vendors and leasing firms</td>
<td>Down payment usually smaller than equity investment for purchase; simple and quick; not subject to extensive restrictions; can be modified</td>
<td>Cost over time usually higher than purchasing; cash flow required to service lease payments</td>
</tr>
<tr>
<td>Commercial finance companies</td>
<td>Availability; willing to take more risks than traditional banks</td>
<td>Higher interest rates than banks; cash flow required to service debt</td>
</tr>
<tr>
<td>Securitizations</td>
<td>Low implicit rate of interest; frees up bank lines of credit; speed good once rated</td>
<td>Rating requirement; cost of substituting performing financial assets for non-performing; documentation extensive; credit enhancements usually required</td>
</tr>
</tbody>
</table>
Mature Stage Funding: Equity and Debt Alternatives

As the small business matures, it is not only able to access a broad spectrum of financing alternatives, it is often in the enviable position of being able to choose among alternatives based on the relative cost of capital. However, management may consider issues other than the cost of capital in making its decision to proceed with a certain type of financing. Examples of these issues may include:

- The desire for some liquidity by management and the founders may dictate the choice of a public offering or a leveraged recapitalization (discussed in greater detail below);
- Positioning the corporation for sale may call for a strategic partnership or a public offering in order to increase the small business's valuation prior to the projected sale date; or
- Securing an institutional investor or strategic partner to demonstrate credibility to a particular market or to validate new technology.

Equity Financing Options

The mature small business is normally able to secure equity financing from sources such as founders, friends and family, angel investors, and venture capital and private equity firms. However, the availability of less expensive equity financing options will usually result in the small business securing financing from:

- Public offerings;
- Retail private placements;
- Institutional investors; and
- Strategic partners.

The discussion of these financing alternatives under "Operating Stage Funding—Equity Financing Options" is generally applicable to the mature stage corporation and, for this reason, is not repeated here. However, a few differences are worthy of note:

- The mature corporation's operations are typically at the point where a public offering is considerably more likely to be completed with a regional or larger investment banking firm. The result is that the small business may be able to solicit interest from several investment banking firms and obtain more competitive pricing and terms for a proposed public offering. The size of the public offering is more likely to be $20 million or more, leading to the possibility that management and the founders may be able to sell shares in the offering or otherwise obtain some liquidity.
- The retail private placement will still be conducted on a "best efforts" basis, but the corporation can often retain a larger investment banker to assist in a placement. The corporation may therefore be successful in raising larger amounts of capital
than is customary in a retail private placement. The investment banker will often seek a commitment from the corporation that the investment banking firm will have a right of first refusal to lead, or a preferential right to participate in, any future public offering. This commitment may enable the corporation to secure more favorable terms from the investment banker for assisting in the placement.

- Institutional investors are more likely to invest in a mature stage entity than an operating stage entity. Because the mature small business has attained some degree of critical mass, institutional investors will view the investment as less risky and will accord a higher valuation to the corporation, thus reducing the amount of dilution to existing stockholders.

Perhaps the one multifaceted truism about equity financing for the mature stage entity is that the corporation:

- Will have a higher valuation than the operating stage entity;
- Will often be in the position of choosing among several attractive offers that address immediate and mid-term capital needs; and
- May be able to use the financing to position itself to receive more favorable terms in the next round of financing as well.

Table 2.5, “Business Considerations for Mature Stage Equity Financing” illustrates the relative advantages and disadvantages of the most common forms of financing at this stage of a corporation’s growth.

<table>
<thead>
<tr>
<th>Common Sources of Mature Stage Equity Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public offerings</td>
<td>Valuation; liquidity for management and founders</td>
<td>Expensive; responsible to stockholders; cost of compliance with complex SEC regulations; disclosure of competitive information and compensation; potential class action litigation risk</td>
</tr>
<tr>
<td>Private placements</td>
<td>Quick; relatively inexpensive</td>
<td>Limited funding; documentation for compliance with SEC regulations</td>
</tr>
<tr>
<td>Institutional investors</td>
<td>Funding availability; speed</td>
<td>Expensive; reduction in control</td>
</tr>
<tr>
<td>Strategic partners</td>
<td>Funding availability; work together to develop business</td>
<td>Time to negotiate; possible conflicts between business and investment objectives; reduction in control</td>
</tr>
</tbody>
</table>
Debt Financing Options

As is the case with equity financing in the mature stage, debt financing is often available to the mature small business from a variety of sources at considerably less cost than that charged to an operating stage entity. While debt financing may carry a lower “all-in” cost when compared to equity financing once dilution and reporting costs are factored in, the facts that (1) interest expense reduces available cash flow, and (2) debt financing generally offers no liquidity for management and founders, may cause debt financing to be considered less attractive. This is particularly true given the fact that equity financings are most frequently closed through the issuance of non-dividend bearing common stock.

In this stage, banks may be willing to provide revolvers or term debt without personal guarantees and the rate charged will often be below the prime rate. There is little doubt that bank financing under these terms would be difficult to turn down in the absence of factors such as a desire for liquidity by management and founders.

One type of debt financing that may offer “the best of both worlds” is a leveraged recapitalization or, as it is commonly referred to, a leveraged recap. A number of institutional investors, principally investment funds and private equity groups, engage in these types of transactions. In general, a leveraged recap features the following:

- An “old line” manufacturing, distribution or service company controlled by one or a small number of stockholders;
- With highly stable and predictable cash flow;
- Whose stockholders want a measure of personal liquidity while retaining daily operating control and a significant ownership stake; and
- Who may want access to additional capital and director-level expertise in conducting add-on mergers and acquisitions.

A leveraged recap typically involves the investor purchasing a portion of its equity stake from the founder or small group of stockholders and the simultaneous redemption or repurchase of stock by the corporation from the founder. The redemption or repurchase is funded through debt financing provided by the institutional investor or, in some instances, a financial institution. In these instances, the institutional investor may provide a corporate guarantee for the repayment of the debt. The net effect, of course, is to increase the ownership stake of the investor, and simultaneously decrease that of the founder or stockholders, in a transaction that is funded using a combination of debt and equity.

The profile of debt financings provided by institutional investors will typically resemble leveraged recaps or mezzanine financings described under operating stage debt financings. These debt financings are extremely rare unless accompanied by an equity kicker or equity pur-
chase through a leveraged recap, as the institutional investor is sophisticated and driven by rate of return targets rarely associated with straight debt instruments.

*Equipment lease financing* is often available from a larger group of lease finance companies when a small business reaches maturity. As such, the implicit lease rate will be lower than that charged to early stage and operating stage entities. In isolated instances, the small business may be in a position to establish a leasing facility with a bank, insurance company or equipment vendor that will finance equipment purchases on an on-going basis that meet set parameters up to an aggregate dollar limitation. At this level, some lease credit facilities may be competitive with, or only slightly more costly than, bank financing. While a lease credit facility may not be appropriate for most small businesses, those with *significant capital equipment needs* may find such a facility a convenient way to finance such needs without committing a significant portion of their revolver to what in essence are longer term investments in equipment.

The relative advantages and disadvantages of the most common forms of mature stage debt financing are illustrated in Table 2.6, “Business Considerations for Mature Stage Debt Financing,” below.

**Table 2.6 Business Considerations for Mature Stage Debt Financing**

<table>
<thead>
<tr>
<th>Common Sources of Mature Stage Debt Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>Lower interest rates due to proven track record; quick; less documentation because relationship may have been previously established</td>
<td>Debt service cost</td>
</tr>
<tr>
<td>Institutional investors</td>
<td>Availability; may add to credibility and increase valuation for next round</td>
<td>Debt service cost; equity kicker may still be required; board membership and more restrictive covenants than banks</td>
</tr>
<tr>
<td>Equipment vendors and leasing firms</td>
<td>Quick; simple documents</td>
<td>Over time, more expensive to lease than buy</td>
</tr>
</tbody>
</table>

**LIQUIDITY STAGE FUNDING: EQUITY AND DEBT ALTERNATIVES**

For purposes of this publication, the “liquidity stage” is defined as the point in time where the founders or management have determined that liquid-
ity for the stockholders is the paramount goal that will outweigh other considerations. Once the small business reaches the liquidity stage, the relative cost of capital becomes somewhat irrelevant as management focuses its efforts on creating a liquidity event. Nonetheless, how the liquidity event is funded may have a significant impact on the benefits derived by the stockholders as well as the costs incurred by the corporation.

**Equity Financing Options**

A "follow-on" or "secondary" public offering is the most common means of a small business generating meaningful liquidity for the stockholders and management in a single transaction. The corporation generally completed its IPO several years previously and the stockholders, founders and management may have been able to generate some liquidity in the years following through sales under Rule 144, "Persons Deemed Not to Be Engaged in a Distribution and Therefore Not Underwriters." However, most officers and directors of public companies will only be able to generate limited or sporadic liquidity through Rule 144 sales due to the following conditions:

- Volume limitations apply to quarterly Rule 144 sales by officers, directors and 10% or more shareholders.
- Rule 144 sales are public and usually receive some negative attention from analysts and institutional investors.
- Investment bankers generally discourage significant and continuing Rule 144 sales due to the real or perceived impact on the market.

The successful small business that reaches the liquidity stage and that is enjoying increasing earnings should be able to complete a follow-on public offering that includes a significant number of shares offered by selling shareholders. These selling shareholders may have contractual rights to sell which were received in purchase agreements (e.g., venture or private equity investors), in prior private placements, or are permitted to register their securities on the company’s registration statement by the board of directors. A follow-on public offering that includes selling shareholders offers a number of advantages for those seeking liquidity, among which are:

- The generation of *substantial liquidity* for a number of affiliates of the corporation in one transaction;
- The underwriters can sell a significant number of shares to existing and new institutional investors without having the kind of *negative impact on the market* that continuing Rule 144 sales might have;
- Institutional investors can increase their ownership stake in the corporation without “chasing” the stock, thus avoiding a *significant run-up in the stock price* as a buying program takes effect;
• The selling shareholders, if dominated by officers and directors, may be able to have a majority of the expenses of registering the shares absorbed by the corporation; and

• The sale of shares by officers and directors, while reducing management's stake, will usually not result in a change in management, meaning that the typical follow-on offering that is successful will generate liquidity without requiring management to cede control to a third party. (For this reason, follow-on offerings can be viewed as management having its cake and eating it too; compare this to a sale transaction, where management usually loses control and/or ends up working for a different management or ownership team.)

A follow-on public offering may be structured as a sale of shares by the corporation, by selling shareholders, or as a combination of the two. In isolated instances, principally those in which the corporation is performing extremely well and has no need for capital, the corporation may seek out an investment banker and conduct a follow-on public offering in which only shares owned by the officers, directors and founders are sold. Again, it is the board of directors that determines who will sell how many shares unless a selling shareholder has contractual rights to have its shares registered.

In the liquidity stage, corporations will typically consider whether a sale of the business is desirable. A well run and profitable small business will often have choices among various suitors that are generally divisible into two groups: financial buyers and strategic buyers.

Financial buyers, as might be expected, are private equity groups and institutional investors that purchase companies for investment purposes. Strategic buyers are usually those buyers that have operations in the same industry as the small business, or in a related industry, and believe that combining the buyer's operations with those of the small business will lead to increases in revenues, earnings, market share or other synergies. Because of this belief, strategic buyers are more often willing to pay a premium over the price that financial buyers are willing to pay.

**Practice Tip.** A financial buyer will in some instances pay a purchase price similar to that payable by a strategic buyer. This generally is the case when the financial buyer has another company in its investment portfolio that would be considered a strategic buyer if it had purchased the small business directly. This type of financial buyer may be ideal due to the substantial financial resources controlled by the financial buyer and the willingness to pay a price that reflects the strategic nature of its prior investment within the small business's industry.

Strategic partners are logical candidates to purchase a small business, due to the fact that the partners have previously conducted their due diligence and are somewhat, if not intimately, familiar with the corporation's business. The strategic partner should have previously executed a confi-
dentiality agreement (which should of course be updated) and may be in a position to close a liquidity transaction quickly. This must often be balanced against the fact that the management may be reluctant to inform the strategic partner of the desire to sell if management believes that the sale may disrupt or otherwise adversely affect the relationship.

Small businesses seeking to maximize stockholder value are sometimes forced to auction themselves in a limited or full auction conducted by an investment banking firm, particularly if the small business is public. Courts have found that an auction, if fairly conducted, will permit the directors to discharge their fiduciary duty to maximize stockholder returns. The auction process can be time consuming, expensive and can result in premature disclosure of the proposed sale of the small business. While steps can be taken to protect the small business from disclosure of sensitive or competitive information until late in the auction process, the fact is that a full auction will often result in competitors seeking information under the guise of being a potential strategic buyer. For this reason, some small businesses will instruct their investment bankers to conduct a limited auction that excludes certain competitors or classes of potential buyers.

A discussion of liquidity resulting from a sale transaction would be incomplete without addressing the "stock vs. cash" issue. If the small business is being purchased by a private buyer, management will typically insist upon cash for the reasons that (i) the stockholders would otherwise end up as minority shareholders in a private company, and (ii) a stock transaction will offer no liquidity. A public company buyer, on the other hand, may be in a position to offer stock in a tax free exchange at a more favorable valuation than it would pay in cash. A significant number of factors may come to bear in considering a stock-based offer, including:

- The *premium* offered to the stockholders of the small business for taking stock, rather than cash;
- The trading history, volume, price range and other attributes of the buyer's stock, including the liquidity demonstrated through the trading volume, number and identity of market makers in the stock, presence or absence of institutional investment, and breadth of research coverage;
- Whether other companies have been issued stock when acquired by the public company and, if so, when shares previously issued may become tradable in the market;
- The length of any *lock-up* that officers, directors and principal stockholders may be requested to execute or that may be applicable under relevant tax regulations;
- The state of the industry in which the public company operates, general economic conditions, the state of the stock market as a whole, and other "macro" economic factors that may affect the value of the consideration paid in stock.
A small business approached by a public company buyer with an offer based on all stock or some percentage of stock must obtain advice from its professionals, particularly its tax advisors, when considering a transaction of this nature. These and other complexities, including how the various factors may interact, need to be understood by the management team and board of directors of the small business. Furthermore, the small business and its advisors may conclude that a stock-based offer is more attractive, but this conclusion may be based on subjective judgments of facts that later change. For this reason, some small businesses will forego a stock-based offer in favor of an all cash offer, even if the all cash offer places a lower value on the corporation. In these circumstances, management of the small business typically makes a determination that the certainty of an all cash transaction outweighs the possible benefits of deferring tax from the sale and any premium the public company buyer is willing to pay through issuance of its stock.

Table 2.7, “Business Considerations for Liquidity Stage Equity Financing” sets forth some of the sources (and relative advantages and disadvantages) of the most common forms of liquidity stage equity financing.

<table>
<thead>
<tr>
<th>Common Sources of Liquidity Stage Equity Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public offerings</td>
<td>Substantial liquidity possible in one transaction; lack of direct impact on market; continued control</td>
<td>Expensive; time consuming; subject to changes in market or business conditions</td>
</tr>
<tr>
<td>Strategic partners</td>
<td>Prior knowledge of business; may be willing to pay premium</td>
<td>Possible negative impact on business relationship; confidentiality</td>
</tr>
<tr>
<td>Financial buyers</td>
<td>Capital availability</td>
<td>Lengthy due diligence process; unwilling to pay as much as strategic buyer</td>
</tr>
<tr>
<td>Strategic buyers</td>
<td>Strategic nature of investment results in higher prices; knowledge of industry or business may expedite due diligence</td>
<td>Disclosure of competitive information; negative impact on employees, customers or suppliers if sale process and possible buyer is disclosed</td>
</tr>
</tbody>
</table>
Debt Financing Options

In the liquidity stage, debt financing is generally limited to loans provided by banks, other financial institutions or institutional investors, the proceeds of which are used by the small business to repurchase its stock. If the debt financing is being used to finance the exit of a founder or member of management, banks and other financial institutions may provide financing only if the remaining members of management provide personal guarantees or other credit enhancements. This is particularly true if the bank believes the exiting founder will be difficult to replace or if the remaining management has limited experience in managing the business. Institutional investors may be more willing to provide debt financing to fund the founder’s exit if they are able to purchase equity in a leveraged recap or if the remaining management team is willing to provide the investor an equity kicker. Again, institutional investors in these transactions will be seeking enhanced rates of return that make a straight debt financing unlikely at best.

Table 2.8, “Business Considerations for Liquidity Stage Debt Financing” sets forth some of the sources (and the relative advantages and disadvantages) of the most common forms of liquidity stage debt financing.

<table>
<thead>
<tr>
<th>Common Sources of Liquidity Stage Debt Financing</th>
<th>Key Advantages</th>
<th>Key Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>Low cost; speed</td>
<td>Need for credit enhancements and continuity in management</td>
</tr>
<tr>
<td>Institutional investors</td>
<td>Availability of funds</td>
<td>Equity participation nearly always required</td>
</tr>
</tbody>
</table>

Summary

Once the corporation has identified the financing alternatives available in its stage of development, the management team must narrow the search by considering specific issues, such as whether equity or debt sources will best serve the corporation, the amount of financing each source can provide, and the advantages and disadvantages associated with each source. Preferred stock is usually the instrument of choice for venture and private equity firms, as well as other institutional financing sources and strategic partners. The terms of early rounds of preferred stock financings will usually reflect the terms set forth in Appendix A. As the corporation grows, the alternative
forms of financing will become more reasonably priced and numerous. In
general, there will continue to be tradeoffs between cost, the time required
to secure financing, and dilution. As the corporation reaches the mature and
liquidity stages, consideration must be given to financing alternatives that
will address liquidity requirements of investors as well as those of manage-
ment. While there may be no one “right” choice for a financial partner, the
well-prepared management team will identify the most likely alternatives
and commence discussions with several sources so that the loss of one source
will not adversely impact the corporation achieving its funding objectives.

* * * *

CASE STUDY HYPOTHETICAL—YOU ARE THE CFO

As the CFO of Dotcom Liquidations, Inc., you have been asked by the CEO
to help her prepare a presentation to the Board of Directors concerning
how Dotcom should consider financing its next 18 months of operations.
Dotcom was formed in the first quarter of 2001 by a savvy ex-shareholder
of MacroSoft named Bill Allen who believed that the “dotcom” expansion
could not last. Mr. Allen thought that there might be considerable demand
for the services of a corporate liquidator that could auction off and sell
servers, routers, and storage devices if e-business didn’t live up to its billing.
Sure enough, after the dotcom market imploded, Dotcom was inundated
with business from venture capital and private equity firms, bankruptcy
trustees, and angel investors that had taken control of failing e-businesses
and wanted to realize some recovery from the remaining hard assets.
Dotcom’s business exploded! The actual and projected financial state-
ments for Dotcom reflect revenues, EBITDA, cash flow from operations
and net income before preferred stock dividends from inception through
the quarter ended December 31, 2002 as follows:

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</thead>
<tbody>
<tr>
<td>Revenues</td>
<td>$450</td>
<td>$900</td>
<td>$1,500</td>
<td>$2,000</td>
</tr>
<tr>
<td>EBITDA</td>
<td>—</td>
<td>50</td>
<td>300</td>
<td>450</td>
</tr>
<tr>
<td>Cash-flow</td>
<td>—</td>
<td>—</td>
<td>100</td>
<td>225</td>
</tr>
<tr>
<td>operations</td>
<td></td>
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<tr>
<td>Net income</td>
<td>—</td>
<td>—</td>
<td>20</td>
<td>50</td>
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<tr>
<td>before dividends</td>
<td></td>
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Mr. Allen and two of his co-founders own all of the outstanding preferred stock of Dotcom. The preferred stock has a 13% annual cumulative dividend but due to the extraordinary financial resources of Mr. Allen and his cohorts, Dotcom has never actually paid the dividend. Mr. Allen and his co-founders are willing to exchange the accrued dividends for common stock if that would be advantageous to Dotcom but otherwise expect to be paid from the proceeds of the next round of financing. The preferred stock may be redeemed by Dotcom in the next 12 months for a redemption premium of $2 million, a substantial amount above the purchase price of $7 million. The preferred stock automatically converts to common stock on a public offering.

The common stockholders of Dotcom include Mr. Allen, a variety of venture capital and private equity firms and a few select institutional investors. Mr. Allen and his two friends own 60% of the outstanding common stock and will own 75% on conversion of the preferred stock. The preferred stock does not have any anti-dilution protection that applies unless Dotcom sells equity at a lower price than previously established. The demise of many e-businesses has left the venture capital and private equity firms desperately seeking liquidity wherever they can find it. Mr. Allen and his friends have no need for liquidity as Macrosoft stock has remained stable and easily salable into the market, albeit at a somewhat lower price than prevailing market prices in early 2001. Control is not a significant issue to Mr. Allen and he is sensitive to the needs of his investors, especially those that provided early rounds of funding to Macrosoft. However, he is a hard-headed businessman who does not make business decisions based on personal considerations. Mr. Allen is,
nonetheless, open to well reasoned arguments as to why a particular course is the best to take in a situation.

Neither Mr. Allen nor the existing stockholders have indicated a desire to invest further in Dotcom. The CEO informs you that she heard from Mr. Allen that he thinks the dotcom liquidation industry could top out in the next two years or so. He evidently believes that as the available supply of equipment begins to decline and prices stabilize as a result of manufacturers finally realizing the effect of cost cuts, the liquidation business will have a harder time finding supplies of equipment to sell and will encounter more price competition from OEMs.

You and the CEO have attractive option positions and, while successful professional managers, neither of you has yet been able to “cash in” on similar positions at other companies. The CEO and you have discussed how you’d both like to attain some degree of liquidity from the Dotcom options you hold, but neither one of you has an immediate need for liquidity. Each of you is convinced that the “window of opportunity” for Dotcom to grow may be open for three or four years, but you fear that Mr. Allen’s analysis might be right and that the window may close in two years.

The capital markets continue to be demanding and difficult, but you know that the involvement and high profile of Mr. Allen, his friends and the venture and private equity investors will likely result in Dotcom being attractive to a variety of investors and investment bankers. Mr. Allen has told the CEO that if a “carrot” needs to be offered to make the next round more attractive, Microsoft will agree to purchase 15% of the common stock or preferred stock for funding and a license to market Dotcom’s Special Liquidation Software® to the telecommunications industry. This software was developed by Dotcom to assist in the valuation of routers and servers and Mr. Allen believes that it can be easily modified and marketed to telecommunications liquidators over the Internet.

The board of directors of Dotcom is comprised of Mr. Allen, his two friends, and two members affiliated with the other investors.

Situational Analysis

1. How is Dotcom’s place in the corporate life cycle classified?

   Practitioner Response: Dotcom is best classified as being in the operating stage. This is based on Dotcom’s financing received to date, growth in revenues, and expansion of its product line to add the marketing of Special Liquidation Software. Mr. Allen’s perception that the market might “top out” in the next two years could be an indication that the corporate life cycle for this business may be significantly shorter than for other companies, further reinforcing the thought that Dotcom is clearly beyond the early, or development, stage.
2. Should Dotcom focus on a debt or equity financing? What factors weigh in favor of one or the other?

**Practitioner Response:** The case study shows a business that is now generating positive cash flow and, due to its nature, has inventory that should have some value as collateral for a borrowing. These facts clearly argue in favor of a debt financing, but must be considered against the forced conversion of the preferred stock on conclusion of an IPO, the conversion of accrued dividends into stock, the "shortened" corporate life cycle that Dotcom may face, and management's desire for some liquidity. The redemption premium makes a redemption considerably less attractive than a conversion, another factor arguing in favor of an IPO. Since Mr. Allen is not too concerned about control, but is sensitive to his investors' needs, an IPO is a good choice under current circumstances. With sales increasing from $4.8 million to over $14 million in the last fiscal year, Dotcom has demonstrated the financial performance that may merit an IPO. However, Dotcom may be better off seeking an interim arrangement under which it secures senior debt to address its short term needs, and look to initiate an IPO in another year or so. Assuming it takes six months to secure an investment banker and complete an offering, Dotcom might be wise to begin the planning for an IPO now, while using senior debt to fund operations in the next year or so. Senior debt is the lowest cost alternative, and it would seem that Dotcom has both the available cash flow and collateral to secure and service this type of debt.

3. Assume that the board of directors debated your presentation in a closed session and then asked you to recommend a single type of equity financing. What would you recommend? Why?

**Practitioner Response:** If forced to recommend a single type of financing, it would be difficult to recommend anything other than an IPO since it addresses more of the needs of management and investors, eliminates the need for capital to redeem the preferred and to pay the redemption premium, provides needed working capital, furnishes liquidity for management, and Dotcom's numbers seem sufficient to interest an investment banking firm. As discussed in the solution to question 2 above, however, there is not always one right answer, even if the question is put to you as the CFO in that manner.

4. If Dotcom's CEO stated that she thought that the Special Liquidation Software® could be marketed directly by Dotcom to telecommunications liquidators, would you suggest Dotcom license Macrosoft or not? If Mr. Allen could be persuaded to have Macrosoft invest capital in the absence of the license, would your analysis change?
Practitioner Response: A direct marketing initiative would have to be evaluated in the context of its cost, possibility of success, and other issues such as whether the license granted to Macrosoft would be exclusive or non-exclusive. Based on Macrosoft's size and market power, one could easily imagine that Macrosoft would not license the Special Liquidation Software without an exclusivity clause. However, due to Mr. Allen's position with Dotcom, it is possible that Dotcom could obtain a right to co-market that would prohibit the licensing of others while still permitting Dotcom to market the software, an arrangement akin to a strategic partnership. One other major fact presented by the hypothetical is that Dotcom has been in the hardware business, and its election to begin distributing its software would take it into uncharted waters. While the margins might appear attractive, many hardware companies have found out the hard way in the past that the marketing of software is a different business altogether. Issues such as whether Dotcom would have to hire a direct sales force, retain representatives, or could work through its existing sales force effectively, would be important to consider. If the cost and time required to conduct or initiate software sales prolong considerably the payback for Dotcom's investment, the Macrosoft license begins to look much more attractive. If Mr. Allen would invest additional capital without a license, it might be possible for Dotcom to fund the development or retention of a sales or representative group, upgrades, maintenance, marketing and the other activities necessary to capitalize on the software opportunity. The capital availability certainly appears to call for a decision to proceed with Dotcom's own marketing plans. Even though your analysis may remain unchanged, calculating the return on investment is still critical in determining whether the cost is justified in proceeding without Macrosoft or even perhaps deciding to license others.

5. Could Macrosoft purchase 15% of the offered shares of Dotcom in a public offering? (Hint: remember that the SEC is dedicated to the disclosure of material facts, not considering an offering's merits or the lack thereof.) What downside for Dotcom is there in such a purchase, if permissible?

Practitioner Response: It is not altogether uncommon for stockholders or their affiliates to purchase additional shares at the time of the IPO. When a significant stockholder, such as Mr. Allen, or his affiliates, such as Macrosoft, engage in a sizeable purchase at the time of the IPO, this is one way of demonstrating to the market that management and its affiliates have confidence in the corporation's future. This type of purchase is usually welcomed by investment bankers as a great selling tool and, in addition, as a way of assuring that this percentage of shares will not be "hitting the market" for a long time to come. Prominent disclosure of such a purchase is required in an IPO prospectus. The downside of such a purchase includes the reduction in available float in the public market, thereby perhaps making the stock price more volatile than it otherwise may be, and concentrating more control in Mr. Allen's hands. This may not be a perception that Dotcom wants to publicly discourage, but management might consider how such a purchase by Macrosoft could be viewed as an "anti-dilution" measure that will simply perpetuate Mr. Allen's control. On the other hand, if the corporation is resigned to the fact that Mr. Allen will continue to exercise controlling influence over Dotcom in the future, there may be little downside to giving a green light to the purchase.
CHAPTER 3

LOCATING THE RIGHT INVESTORS AND UNDERSTANDING THEIR OBJECTIVES

Now that the reader is familiar with the corporate life cycle and both equity and debt financing options, as well as the types of investors that can be expected to finance the small business, the process of identifying specific investors must begin. A practical approach is advocated, one that will use Internet-based resources to focus on specific Web sites that provide access to investors offering different types of financing, and guidance for Web-based searches that can generate investor profiles. Each discussion in this Chapter is accompanied by information intended to assist the reader in understanding the priorities and goals of different types of investors.*

* Caution. Commentary in this chapter is for discussion purposes only. Neither the AICPA nor the author endorse or recommend any of the Web sites, search engines, or investors referenced in these materials. The identified Web sites, search engines and investors are provided merely as examples of how the industry participant, practitioner, or small business management team can use the Internet to research investors interested in funding small business opportunities. AICPA and the author expressly disclaim any liability or obligation arising out of use of these examples by readers. Such persons are cautioned that neither AICPA nor the author have investigated or conducted due diligence concerning such Web sites, search engines and investors. Prior to engaging or entering into any transaction with any of the foregoing, the industry participant, practitioner or small business management team must conduct their own due diligence and make their own determination of whether or not to engage, or conduct business with, any of the foregoing. AICPA and the author expressly advise industry participants, practitioners and small business management teams to conduct their own research through the Internet, through their own personal contacts, and through public records in making a determination whether to do business through, or with, any of the Web sites, search engines, or investors referenced in these materials.
IDENTIFYING EARLY AND OPERATING STAGE INVESTORS

Since founders, friends, and family are company specific, these early stage investors are not covered in this discussion. Nonetheless, due to the fact that friends and family often have prior relationships with the founders and may therefore reach a “comfort level” far faster than an outside investor, the founders would be remiss if they failed to pursue opportunities to secure financing from family and friends.

The next category of early stage investors are “angel” investors who are typically high net worth individuals who may have some familiarity with the industry in which the small business operates. Angel investors can be identified by a variety of means, including through:

• *The Angel Capital Electronic Network*, at http://ace-net.sr.unh.edu, like other Internet portals, was established to allow small businesses and angel investors to exchange information and facilitate early stage investments between $250,000 and $5 million. The corporation fills out an application and pays a $450 subscription fee, at which time its information is placed in the database. Angel investors can scan the database and contact companies in which they are interested. The network was organized in 1997 and indicates that it has facilitated over $700 million in financing with a transaction average of $1.2 million. The network and its Web site were established by the University of New Hampshire.

• *BusinessPartners.com*, at http://www.businesspartners.com, is an Internet resource that offers services similar to those of the Angel Capital Electronic Network.

• *Seed Capital Network*, at http://www.seedcapitalnetwork.com, is another Internet resource similar to Angel Capital Electronic Network.

• *Garage.com*, at http://www.garage.com, is a Internet resource that provides small business investment opportunities that match an investor’s identified interests.

• *University Angels*, at http://UniversityAngels.com, is an online angel investor network that is devoted to alumni of the world’s top universities and contains hyperlinks to approximately 75 angel networks that are affiliated with specific universities.

• Many certified public accountants, attorneys, investment bankers, and commercial bankers have established relationships with angel investors who may be current or former clients. Also, angel investors who have served on boards of directors and advisory boards can often be identified through public filings, fellow entrepreneurs, and professionals.

• Angels or their advisors sometimes attend industry conventions and conferences to update themselves on the latest industry developments. Many investment banking firms send representatives to industry conventions for similar reasons.
• Angels can sometimes be accessed through business incubators and business networking groups that provide support to early stage entities.

With respect to venture capital and private equity groups, the following are among the various ways that management teams can identify these investors:

• The Venture Capital Database, at http://www.findingmoney.com/vc, has a complete and alphabetized listing of active venture capital firms throughout the U.S. organized by office locations, principals, investment preference, minimum investment, transaction size, and fund size.

• Vfinance.com, located at http://www.vfinance.com, has included within its Web site a complete (free) listing of the venture firms located in the U.S. This listing does not have location, contact information, and the other information provided by the Venture Capital Database, but specific contact information can be accessed using the search engine on the site for a small fee per listing.

• VcPro Database, located at http://www.vcaonline.com, has a downloadable directory of 3,000 venture firms and funds worldwide, including contact information and investment criteria. This database includes listings for 1,700 U.S. firms or funds, 700 European firms or funds, and 460 Asian firms or funds, among others.

• Directory of Venture Capital, which can be purchased from Amazon.com and is authored by Kate Lister and Tom Harnish, is a soft cover book that includes contact information and investment criteria for over 600 U.S. venture firms and funds.

• Private Equity, at http://privateequity.com, contains a list of 1,345 private equity firms, with hyperlinks to each private equity firm’s own Web site that generally has all necessary contact information and investment criteria. Some of the listed firms are also listed in the venture capital directories, due to overlap as well as the fact that a number of venture firms also provide private equity for leveraged recapitalizations, buyouts, and mezzanine financing.

• When searching “private equity” on the Internet, most search engines will reference a number of Web sites maintained by “major bracket” investment banking firms such as Credit Suisse First Boston, Merrill Lynch, J.P. Morgan Chase & Co., Bear Stearns and First Union. These investment banking firms often maintain affiliated private equity funds and have direct access to the principals of a number of large, independent private equity groups.

• A number of private equity firms such as GE Equity Capital Group and Hunt Private Equity (affiliated with the Hunt family of Texas) are accessible through search engines using “private equity group” or “private equity groups” as the key search terms. These firms provide hyperlinks to their Web sites that list their contact information and investment criteria.
Several private equity groups are well known due to their published investments in private firms that later are sold or become public. Examples of these firms include, among others, The Shansby Group, Trivest, Inc., Patricof & Co. Ventures, Inc., Golder Thoma Cressey Rauner (GTCR), Bain Capital, Weiss, Peck & Greer, EOS Partners, L.P., and Hicks, Muse, Tate & Furst.

An Internet search will find a number of sites with listings for either (a) actively investing U.S. venture firms, or (b) private equity firms. Sites in this area organize themselves around common terms. For example, a search using the terms private equity firms reveals a Web site called PrivateEquity.com that lists private equity firms. While these lists may not be exhaustive, they provide an excellent starting base from which a small business management team can begin to build its list of prospective investors.

Because retail private placements and early stage public offerings are most often marketed through retail and regional investment banking firms, these categories of operating stage investors are addressed together below. Rather than focusing on the individual purchaser of the securities, the identification of investors in retail private placements and early stage public offerings is a direct function of the investment banker that is selected. Hence, the following are some of the means by which the management team can identify investment banking firms specializing in marketing these types of securities:

- **IPO Underwriter Search**, at http://www.ipo.com, contains a listing of investment banking firms across the U.S. that have underwritten or participated in the underwriting of initial public offerings. This list does not appear to have been updated recently but the list does provide phone numbers and office locations for each firm, so cross checking is facilitated.

- **Investment Banks**, at http://www.vfinance.com, provides a more updated, albeit more limited, list of investment banking firms that have underwritten initial public offerings.


- When searching "private placement" on the Internet, most search engines will refer to the Web sites of private equity groups and angel investors, rather than investment banking firms that assist in raising financing through retail private placements. Rather than searching through this mechanism, the management team should refer to the lists of investment banking firms identified through the means discussed above and refer to each firm's own Web site to ascertain if the firm is active in funding retail private placements.
**Practice Tip.** When seeking to identify investment bankers for an IPO, special attention should be paid to any recent filings for IPOs by companies that have operations in the industry in which the small business is active. The filing usually means that the lead investment banking firm has one or more analysts in-house (or knows of independent analysts) that will be providing research coverage. If the investment banking firm already covers one or several companies in an industry, or relies on an outside analyst that provides such coverage, it is more likely to be interested in providing financing for another corporation in that industry. This may also hold true for a retail private placement, particularly if the investment banking firm believes that it may be positioned to secure the lead underwriting position in the subsequent IPO if it assists the small business in financing its current needs in a private placement. The management team should carefully consider this possibility, as it may be an inducement to the investment banker but could also act to the disadvantage of the corporation if other investment bankers later express interest in leading the IPO and the corporation is precluded from negotiating with them.

**Practice Tip.** Another way to identify an investment banking firm that may be a good lead underwriter is to access the stock symbols of the small business's public competitors through the Nasdaq or NYSE Web sites. Once the stock symbol is accessed, the reader can “click through” to the list of firms that provide research coverage on the competitor's stock. These firms are excellent prospects for IPO and other forms of funding for the small business as it is clear they have analysts that already cover the industry. Appendix B, “Level 3 Communications, Inc. Screen Shots,” shows the successive screen shots that illustrate how to find the investment banking firms that provide research coverage for a sample company, Level 3 Communications.

**Caution:** Keep in mind the distinction between a retail (small, probably $2 million or less) private placement and an institutional (large, probably $5 to $10 million minimum) private placement when reviewing investment bankers' Web sites. Many investment banking firms will present their services as including “private placements,” without clearly describing the type to which they are referring. One is safe to assume that the larger the investment banking firm, the more likely any reference to private placements means institutional placements.

In general, it is more difficult to discuss the ways in which the corporation may identify strategic partners or institutional investors due to the “company specific” nature of these investments. However, a few points are worthy of note:

- Strategic partners may be participants in the corporation’s supply chain or customers that place the small business’s technology or product within their own products. If the strategic partner is driven by the need for access to technology, the small business may be in a position to approach a prospective partner and obtain capital for assuring such access.
• The investment banking firms identified through the means described above often have ongoing relationships with, and represent or consult to, large companies that are investment banking clients of the firm. Investment banking firms also maintain strong customer relationships with institutional investors to which they may refer funding opportunities. The existence of these relationships underlies the strongest argument in favor of a small business retaining an investment banker, even at an increased cost of funding. The argument: a small business will have direct access to the decision makers at a large company or institutional investor without having to “climb the ladder” within the organization to eventually reach the decision maker, if it is even successful in doing so.

While this access comes at a price, the management team must factor in these relationships when considering whether to retain an investment banking firm to approach a strategic partner or institutional investor, and the increased likelihood of success that may come through use of an investment banker.

**OBJECTIVES OF EARLY STAGE AND OPERATING STAGE INVESTORS**

Early stage investors invest in a small business with the expectation of generating high annualized rates of return. While this expectation may be common to nearly all early stage investors as well as many operating stage investors, there may be a variety of other objectives that characterize an early or operating stage investment, depending on the investor. Angel investors, for example, typically aim to invest in:

• Small businesses that they understand well or in which they have prior management or investment experience;

• Corporations that need informal advisors or members of the board of directors that know the types of issues the corporation will face; and

• Opportunities that will provide investment returns of 20% annually or more, depending on the nature and amount of prior investment (e.g., if an institutional investor has already invested, the angel may be willing to accept a somewhat lesser rate of return).

Angel investors may be persuaded to invest based in part on their intuition and the commitment that the founders have made to the corporation. If angels believe that the business plan is compelling, that management is committed through investment of personal assets, time, and energy, and that the technology or product has both market and sales potential worthy of pursuit, the angel investor may be more inclined to invest. This should be contrasted with the case of the institutional investor that invests in later
stage businesses, where the presence or absence of professional management may be the determining factor in whether an investment is made.

Venture capital and private equity firms will generally invest in small businesses that facilitate these investors meeting the following objectives:

- The corporation must conduct operations in an area of concentration for the venture or private equity firm or, if not, the investor typically must have a co-investor who has the personnel to evaluate the opportunity and recommend it;
- The investment must meet the minimum dollar amount required by the investor without the investor controlling 75% or more of the corporation;
- The venture or private equity investor will seek long-term capital gains within a five to eight year window that result in annualized rates of return of 35% to 45% or more;
- The prospects of the corporation and its projections must support a valuation that will allow the venture or private equity investor to achieve liquidity within the five to eight year window and to meet or exceed the targeted rate of return; and
- Mechanisms must be in place to assure some degree of participation in the management of the business and an increasing degree of control if the corporation fails to meet its performance benchmarks.

While the purchasers of a retail private placement may expect annualized rates of return more often associated with angel investments, retail private placements will generally be priced at levels closer to the pricing of a "venture public financing" or early stage public offering. In addition, since the placement or public offering is marketed through the investment banking firm(s) to its customers, it is the investment banker who typically establishes the objectives on behalf of the investors. These may include:

- A valuation in the placement or offering that permits the shares of the corporation to trade at a 100% to 200% premium to the placement price at the time of the IPO or at a 100% premium to the public offering price one year after the IPO;
- A corporation doing business within an industry covered by the investment banker’s analysts;
- Providing the private placement investors an early window to register and sell all or a portion of their shares into the public market, or at least at the same time as any insider selling that is permitted once the “lock-up” of the insiders has expired;
- A corporation that evidences prospects for growth that will support the valuation in the placement or offering; and
- A management team that understands the fundamentals of the business and has been successful in implementing the corpora-
tion's growth plan. The team will usually exhibit some depth of experience or access to board members or advisors with considerable experience.

**Practice Tip.** Some investment banking firms, like venture investors, have taken the approach that management is the single most important ingredient in the success or failure of a business. An early stage management team without significant prior experience may be successful in convincing angel and "retail" investors to fund the corporation (e.g., based on the technology or products marketed by the corporation). However, a good general rule is that the larger the entity grows, the greater the likelihood that an investment banking firm will insist on addition of professional managers to key posts as a condition to funding. While some small businesses may be in a position to resist such efforts, others without the negotiating leverage to withstand such demands may find themselves in the position of having to add management when resources are limited at best. Planning ahead for management additions and disclosing these plans to investment banking firms may be the best way to address some of the concerns that might otherwise arise.

Private equity groups sometimes provide funding for a leveraged recap, management buyout or for a later stage business. In these scenarios, the private equity group's objectives are different from those previously described, to wit:

- Market dislocations, consolidations and changes create structural opportunities in the corporation's industry;
- The corporation has a strong management team;
- The business has a highly developed infrastructure and strong fundamentals;
- Additional revenue generating opportunities exist through strategic acquisitions, expansion into complementary product or service lines, or development or licensing of technologies; and
- The investor can realize annualized rates of return of 25% or more over a three to seven year window from the date of funding.

**IDENTIFYING MATURE AND LIQUIDITY STAGE INVESTORS**

As noted in Chapter 2, "The Advantages, Disadvantages, and Timing Issues Associated with Alternative Financings," investors in mature and liquidity stage corporations are most often:

- Institutional investors;
- Strategic partners;
- Private placement investors;
- Public offering investors;
• Financial buyers; and
• Strategic buyers.

The immediately preceding section addresses how the corporation may go about identifying venture and private equity groups, strategic partners, and investment bankers that market private placements and public offerings. If one equates a strategic buyer to a strategic partner, it is clear that strategic buyers are identifiable through an analysis of suppliers, customers, and other third parties that may utilize the corporation's technologies or products. Financial buyers are often private equity groups and buy-out firms that specialize in going private transactions or in assembling portfolios of companies that can later be sold or taken public. Most investment banking firms have relationships with buy-out firms that may offer some advantage to the management team looking to effect a sale transaction with a financial buyer. Furthermore, many of the private equity groups identified through the means described above have a portion of their portfolio allocated to buy-out transactions that meet specific criteria. When searching "buyout group" and similar terms, the reader will find that most of the listings that appear are those of private equity groups. Again, many of the best known private equity groups such as The Shansby Group, Trivest, Patricof, Golder Thoma Cressey Rauner, Bain Capital, Weiss, Peck & Greer, and Hicks, Muse, Tate & Furst are among the most active buy-out firms.

Objectives of Mature Stage and Liquidity Stage Investors

The obvious objective of investors in mature and liquidity stage businesses is to purchase their securities in the corporation at a valuation that will allow them to realize profits from an increasing enterprise value. In the case of strategic and financial buyers, their objective is to set the purchase price low enough so as to realize this objective sooner, rather than later. The issue, then, is how the investor calculates the valuation that it is willing to use when investing in the enterprise. Valuation is also the key to how an investment banking firm prices a public offering and the percentage of the shares it will sell to the public. Knowing in advance that the investor will be arguing for a lower valuation, it is important for management to understand the basic valuation model used by investment bankers and private equity firms so that management can more effectively argue its case and prepare counter-arguments in advance.

Public Company Valuation

When an investment banker values a public company, it generally assembles several commonly accepted metrics and prepares a list that presents the
metrics of the small business and of comparable public companies. For example, an investment banker may calculate enterprise value as a multiple of earnings, EBITDA, revenue or operating cash flow, depending on the nature of the corporation's business. These calculations are compared against similar statistics assembled for public companies that are considered "comps" to the private company. The determination of "comps" is as important as the selection of the metrics that are used. For example, if the small business is engaged in oil and gas exploration and production (e&p), the investment banker might calculate metrics such as proved reserves, probable reserves, earnings, and EBITDA and compare these metrics to those for other e&p public companies to arrive at a range of values.

An analysis of "comps" will usually result in the investment banking firm eliminating valuations of other public companies that are unreasonably high or unreasonably low, based on factors such as the company's size, particular market niche, or other factors that vary from that of the small business. If the small business has total annual revenues of $75 million, public companies with annual revenue of over $500 million will typically not be considered to be a fair "comp." Likewise, companies with revenue of less than $30 million may not be considered to be a fair "comp." While each company has to be valued on its own merits, the investment banker will generally strive to assemble a list of comps that most closely resembles the small business in the metrics chosen and in measures such as revenue, operating income, and net income. If the average comp trades at a multiple of 10X EBITDA, the investment banker will usually indicate that the small business must price its securities in a public offering at something less than this multiple in order to "leave something on the table for the public." This not coincidentally results in a higher likelihood that the stock will trade up in the market after completion of the offering, thus giving the investment banker's clients some appreciation on their investment in a relatively short time frame.

On occasion, a small business is engaged in a business that is of such a unique nature that few, if any comps, are available. In these cases, the investment banker is often forced to base the valuation analysis on whatever comps may be available, and applying some adjustments to the available comps. Alternatively, the investment banker may look for companies in related industries that, while not direct comps, may give the best approximation of value for the small business. For instance, if a small business is engaged in production of an Internet "appliance" that provides wireless access to the Internet and the technology is so new that it has no direct competition, the investment banker might examine metrics from manufacturers of cell phones, organizers and kiosks when attempting to value the small business. As one might expect, valuation is more of an art than a science and, to some degree, may vary based on factors such as whether the IPO window is open or if the corporation is engaged in a particular business that is then enjoying high valuations in the market.
Chapter 3: Locating the Right Investors

Private Company Valuation

Private company values are somewhat easier to calculate as most purchasers of private companies will price acquisitions at a multiple of EBITDA. For private companies in low tech or old line manufacturing activities, the typical multiple ranges from a low of 3 to 3.5X EBITDA to a high of 5X EBITDA, while a high technology private business might change hands at multiples of 5.5X or 6X EBITDA. When the market for “dot com” ventures was overheating, some private companies were changing hands at multiples of sales or multiples of losses that had little basis in rationality. Suffice to say, the market eventually corrected and these valuations have long since disappeared.

One of the key issues that must be negotiated in acquisitions of private companies is the “addbacks” and “deductions” that are made to/from the EBITDA calculation. When contemplating a sale transaction, many private companies will seek to limit expenses or reduce discretionary items such as marketing or advertising in order to increase EBITDA. To the extent EBITDA has been reduced by legal or accounting expenses attributable to the sale or will increase in future periods as owner’s distributions are replaced by fixed salaries, the owner will seek to negotiate addbacks to EBITDA that reflect these and similar items. The purchaser, in the meantime, will of course be seeking to decrease EBITDA by evaluating reserves for inventory and receivables, adjusting below market rents to amounts consistent with market conditions, and factoring in the salary cost of additional employees that might be necessary to operate the business as it grows. Negotiations surrounding these points are often long and contentious and may fall in the category of “deal breakers” dealt with in Chapter 6, “Deal Breaker Issues.”

One other point is worthy of mention when considering a private corporation valuation. Many investment bankers that provide M&A advisory services maintain databases of acquisition prices paid in private transactions in which they were involved. While confidentiality provisions may prohibit the disclosure of the purchase price, the investment banker can often discuss multiples paid in a context that does not identify the parties to the prior transaction. For the small business management team, this knowledge can sometimes be critical to maximizing the enterprise value in a sale transaction if other sources of information are limited.

Practice Tip. Although the valuation points addressed above are frequently the most obvious issues, it should be clear that sale transactions, in particular, may vary in valuation based on whether the transaction is all cash, all stock, or some combination. A seller receiving all cash will generally receive a valuation that is less as a multiple of EBITDA than a seller who takes all stock. The purchaser is often willing to pay more in stock, but the seller who accepts stock will be subject to the risk of a fluctuating stock price and to lock-up
provisions imposed by contract or tax regulations. Most private companies will not sell to other private companies for stock, due to the absence of a liquid market and the clear disadvantages of being a minority shareholder in a private company. For this reason, acquisitions using stock to fund the purchase price are usually completed by public companies or companies that are going public in a “roll-up” transaction.

Purchases of public companies by other public companies may be stock or cash transactions, but unlike the purchase of a private company, the management team of a public company cannot receive consideration in the form of an earn-out since any future consideration would belong to all of the shareholders. For this reason, golden parachutes and severance packages are used to reward management teams of public companies that are acquired by other public firms. Valuations in public/public acquisitions are fairly straightforward since each party is required to secure a fairness opinion from its own investment banker and the purchase price is normally negotiated at a level above prevailing market prices. Neither of these facts should be taken as an indication that the valuation is correct, but the investment banker who renders a fairness opinion is required to perform a number of different valuations that are publicly disclosed in the proxy statement that discusses the acquisition. These valuations are typically a discounted cash flow analysis, a multiple of earnings, EBITDA or other metrics, a “comp” analysis of the prices paid in similar acquisitions, pro forma financial analysis, and perhaps a contribution analysis.

**Debt Financing**

Since the term “investment” connotes an equity investment as opposed to debt financing, the foregoing discussion does not directly address the identification of sources of debt financing. Nonetheless, as the reader learned in Chapter 2, “The Advantages, Disadvantages, and Timing Issues Associated with Alternative Financings,” many institutional investors will purchase equity and debt instruments simultaneously when funding a small business. In general, if the debt is funded using convertible instruments or is accompanied by warrants, the negotiation with the institutional investor will focus on the valuation of the corporation and warrants on an “as converted” or “as exercised” basis. If the debt is not convertible or is not accompanied by warrants, the corporation will presumably be in the favorable position of having secured debt financing that has no equity kicker attached.

The venture capital firms, private equity groups and buy-out firms identified above usually provide mezzanine and other types of structured debt financing to the small business. Accordingly, if the management team is seeking funding for a leveraged recap or for a mezzanine round, the investor
should be identified by reviewing the "investment" criteria and determining which institutional investors would be most interested in providing this funding. For example, Softbank Capital Partners specializes in providing late stage mezzanine funding of $10 million or more to significant Internet businesses, while Pacific Mezzanine Fund invests in middle market companies located primarily in the western United States in amounts ranging from $1 to $3 million. A careful evaluation of prospective debt financing sources, whether identified through management's own research, professional contacts, or investment bankers, should result in the small business developing a profile of debt financing sources that fit the corporation's needs and stage of development.

This discussion intentionally omits information on identification of banks and lease financing sources. Banks are easily identifiable through a wide variety of sources. As discussed in Chapter 1, "Identifying Financing Options Available to Growing Small Businesses," lease financing is typically provided by equipment vendors. Searching the term "lease financing" will generate a wide variety of lease financing options offered by vendors, banks, and specialty finance companies.

**SUMMARY**

The Internet has placed a powerful source of information at management's fingertips that can be used to identify a broad variety of institutions and individual investors. These sources include angel investors, venture and private equity firms, and investment bankers. Just as institutional and individual investors have industry or business preferences for their investments, these investors also have established objectives tied to valuation, rates of return, minimum investment amounts, and other criteria they have developed. Valuation will vary based on whether the corporation is public or private, and is generally based on well-accepted metrics that are common knowledge in a particular industry or transaction type. Debt financing sources that use equity kickers to achieve targeted rates of return will also use a valuation analysis to determine enterprise value on an "as-converted" or "as-exercised" basis.

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**CASE STUDY: CLIENT MEETING PREPARATION**

Clients are coming in for an advisory meeting regarding their need for investor funding. They are anxious to find the right investor and the funding necessary to solidify their corporation's position in their industry. Here are some common questions and scenarios derived from the Chapter reading. How would you respond?
Situational Analysis

1. What are some of the ways the management team can identify investment banking firms active in conducting IPOs and private placements?

**Practitioner Response:** Investment bankers for IPOs can be identified through a search of recent filings for public offerings by companies in the same industry as the small business, through Web site searches of the Web sites described in these materials and otherwise accessible through the Internet, and through a search of the Nasdaq or NYSE Web sites to determine what banking firms are writing research on a competitor. Also, reviewing individual investment banking firm Web sites to determine if they are actively seeking companies in the small business’s industry, and the financing services in which they are active, can be an important way to narrow down the list of suitable candidates. Attendance at conferences sponsored by investment banking firms, and conferring with “friendly competitors” at trade and industry shows, can also be informative in identifying some of the investment banking firms active in IPOs or private financings within your industry.

2. What is the most important criterion used by institutional investors and investment bankers to evaluate a financing opportunity before deciding to proceed with the next step of meeting with a management team?

**Practitioner Response:** Evaluation of the strengths and weaknesses of the management team is the most important criterion used by institutional investors and investment bankers in determining whether to proceed to the next step of actually meeting the management team. Although valuation will always be an enormous issue and cannot be discounted, the lack of experienced and seasoned management will kill a financing much more quickly than valuation disagreements. Why? Because if the investor likes the corporation and the management team enough, it will negotiate hard on valuation but is unlikely to “walk away.” This is not the case if the management team is perceived as being weak. If the management team does not have the skill set necessary to capitalize on the opportunity, it will matter little to most investors how good the opportunity appears to be.

3. What is the difference between a retail and an institutional public offering? Retail or institutional private placement?
Practitioner Response: A retail public offering is sold principally, or exclusively, to individual investors. An institutional public offering is sold primarily to institutions. Retail public offerings are often priced below levels at which institutions can invest, or may have such a small number of shares to be offered that the institutional investor cannot, as a practical matter, invest. Retail private placements are likewise sold to individual investors (or may include one or two small institutions), while institutional private placements are larger and marketed only to institutions. Again, as is the case with retail and institutional public offerings, size is the principal means of differentiating retail and institutional placements. Most retail placements will be under $5 million and most institutional placements will be $10 million or more.

4. What rates of return do early and operating stage investors typically seek? What factors do investment bankers consider when pricing a private placement for an early or operating stage entity?

Practitioner Response: Early and operating stage investors are usually looking for rates of return on equity that may exceed 35% annually. Generally, the further the corporation has advanced in its development, the lower will be the rate of return that the investors will seek. Therefore, a corporation in the operating stage will likely be able to secure investors with more reasonable expectations, perhaps in the range of 18% to 25% per year. The investment banker will consider factors such as management experience, prospects for continued growth, and whether the investment banking firm has an analyst with the expertise to write research on the corporation once it is public. They will also consider what valuation must be given to the corporation currently and at the time an IPO is expected, and the rate of return to the placement investors that these valuations imply, and what lock-up terms will apply to the private placement investors.

5. How does an investment banker place a value on a private entity about to go public or sell?

Practitioner Response: Valuations for private companies about to conduct IPOs are arrived at principally by the investment banker analyzing “comps.” This analysis involves review of competitive companies within the same industry as the small business (or within the closest comparable industry) and consideration of the “metrics” of these competitors versus the small business. The metrics considered are usually industry specific and will relate to factors such as how the comps trade or are valued based on multiples of sales, EBITDA, operating earnings, cash earnings, or other factors. Once the comps have been developed, those that are less comparable due to size or other differences are eliminated and the investment banker will arrive at a small group of the closest comps. The small business can expect its IPO to be priced in a range on the low side of the comps, thus “leaving something on the table for the public.”
6. What are typical “addbacks” that a small business would seek to have included in EBITDA when calculating enterprise value? What are some of the common deductions a potential purchaser or investor may make from EBITDA when calculating enterprise value?

**Practitioner Response:** Customary addbacks sought by a small business owner will include accounting, legal, and other professional fees attributable to the transaction that have been paid, excess compensation received by the owner in prior periods that will not be paid in future periods, salaries of personnel whose positions will be eliminated due to consolidation of administrative, marketing or other functions, any tax or other savings that will be realized as a result of the transaction, and excess benefit costs that may not be incurred in future periods. The purchaser will seek to decrease EBITDA by adding back amounts to reflect any below market rents (when, for example, the small business owner owns the building occupied by the corporation), the salaries of additional personnel that will have to be hired since the small business owner may have performed several jobs, additions to reserves or reductions in inventory that should have been taken in prior periods, and imputing interest where debt instruments carried below market rates or were denominated as equity securities, but were debt equivalents.
CHAPTER 4

INITIATING THE PROCESS: FROM BUSINESS PLAN TO TERM SHEET OR LETTER OF INTENT

The previous Chapters have presented (1) financing options available to the small business corporation (the "what"), (2) the reasons that a small business should select a particular financing vehicle (the "why"), and (3) some of the means by which prospective investors can be identified (the "who"). This Chapter will address (a) how a small business corporation begins the process of seeking a financing commitment from among prospective investors, and (b) what it can expect when it and an investor reach a mutual understanding of terms from which definitive agreements can be prepared. Among other topics, this Chapter provides a summary outline of the typical business plan submitted by small businesses to prospective investors and addresses what the management team should expect in the course of early stage discussions with prospective investors. As the reader is aware, the preliminary understanding of financing terms between an investor and the corporation is usually evidenced by a term sheet or letter of intent. Appendices A, C, D, and E include sample term sheets and letters of intent drawn from "real life" transactions that will familiarize the reader with the forms of these documents and terms that are customarily included.

The reader should also keep in mind the timing issues discussed previously when considering the material in this Chapter. A debt financing through a bank or other financial institution can be expected to close much more quickly than an equity financing because the bank is primarily concerned with the value of its collateral, the creditworthiness of the borrower, and the priority of its security. Consequently, due diligence by a banker will be focused on historical and projected financial performance, collateral valuation and audits, receivable collection rates, inventory turns, and lien priority issues. The equity investor is concerned with these points as well
as management, operations, capital structure, regulatory compliance, and a host of other issues. Since equity investors rank behind creditors of the corporation and are in a very real sense "unsecured," equity investors will generally conduct comprehensive due diligence that takes considerably longer to complete than the diligence performed by a bank.

THE BUSINESS PLAN

Entire series have been written on how to prepare a business plan and, as such, this publication is not designed to teach how to write a business plan. Rather, the discussion is focused on preparing the business plan in a form most useful to investment bankers, venture capital and private equity investors, and angels.

A common question that arises in preparing a business plan is the optimum length of the plan. While the author is familiar with business plans that are as short as 12 pages and as long as 200 (including exhibits), a good rule of thumb is to limit the plan to not more than 15 to 25 pages, exclusive of historical and projected financial statements. Why? The answer is that (1) many investors and investment bankers will begin by having an intake analyst read the executive summary and reject funding requests from small businesses that do not fall within the investor’s areas of concentration or that are seeking financing outside the range of funding normally provided, (2) if the executive summary meets the investor’s investment criteria and piques the analyst’s interest, the investor or investment banker will usually have the analyst review and deconstruct the projections and assumptions, and (3) the remainder of the plan will then be analyzed in order to determine what areas will be covered in question and answer sessions.

Practice Tip. Overly long business plans slow down the analysis performed by the investor or investment banker and may deter the investor or banker from seeking answers in a face-to-face meeting. When a small business is preparing the plan for presentation to prospective investment bankers, the author has found the need for a short business plan to be even greater since many investment bankers operate under significant time constraints and will only read the executive summary until their analyst has given the plan a "thumbs up." In other words, the business plan is principally a marketing document intended to "get management’s foot in the door" and is neither a disclosure document nor a comprehensive analysis of the business’s operations. A good rule of thumb is "the more concise and to the point, the better."

The well prepared business plan will typically encompass the following sections.

• An executive summary ranging from two to five pages that includes a discussion of:
— A brief overview of the business;
— Significant growth drivers (both industry and company specific);
— Growth in revenues, profitability and/or margins, and the effect on operations;
— Factors that differentiate the business from competitors and a brief analysis of the competitive landscape;
— A review of key members of the management team and the most relevant portions of their backgrounds;
— A historical financial summary;
— Summary projected financial information;
— Funding requirements;
— A brief use of proceeds; and
— Contact information.

• An industry overview, including growth drivers, sales and marketing channels or the means of distribution, segments, and where the corporation fits within the industry;
• A discussion of the corporation's business, including strategy, products, sales and channels of distribution, marketing, customers, production, trademarks and service marks, facilities, employees, and competition;
• A review of the corporation's management, including officers, directors and key employees, as well as their ownership interests in the corporation; and
• An operational analysis, where appropriate, and both historical financial information and projections. The projections should be accompanied by a statement of assumptions used in preparation of both the projected income statements and projected balance sheets.

Many investors and investment bankers are satisfied if the corporation presents projections covering three years, with the presentation reflecting a month by month statement of operations for the first year and an annual statement of operations for the subsequent two years. Other investment banking firms and investors will ask for a five-year set of projections prepared on a similar basis. While many small businesses may find it difficult to prepare meaningful five-year projections, the investor or investment banker is often interested not only in the projected results in years four and five, but also whether management (and, in particular, the financial officers) have used reasonable assumptions on a consistent basis in preparing the projections. Most investors and investment bankers are well skilled in questioning the assumptions that underlie a small business's projections and will often have "done their homework" in terms of ascertaining the metrics that are commonly achieved in the corporation's industry.
For example, if a small business is engaged in retail sales of golf equipment over the Internet and is seeking funding for expansion, the well-prepared investor or investment banker will have researched the number of “click-throughs,” “sales per hit,” and dollar amount of sales per order that competitive Web sites enjoy. If the small business’s projections reflect assumptions about these or similar metrics that are inconsistent with what others in the industry experience, the small business had better be able to support why its results will be different or it will suffer a significant loss of credibility.

**Practice Tip.** Too often, the management team of the early or operating stage small business does not realize that the typical venture investor or private equity group has a vast amount of experience in evaluating projections and assumptions. *Moreover, these investors often understand the corporation’s business nearly as well as, or perhaps better than, the management team.* This is particularly true if the venture or private equity investor has an industry concentration and has funded other companies active in the same industry as the small business. Although speed is important in preparing the business plan and closing a funding, the small business will benefit greatly from the management team taking the extra time and effort necessary to carefully prepare, evaluate, and revise the projections and assumptions. If the management team demonstrates a comprehensive understanding of its business, the business’s significant metrics and the resources necessary to achieve success, the chances of the corporation obtaining funding will be greatly enhanced. Since the business’s metrics are ultimately incorporated within the projections and assumptions, most investors will focus on whether or not the small business can support the metrics it has used in preparing the projections and assumptions.

This is not to say that all good management teams with excellent projections and assumptions receive funding. The investor must ultimately be convinced that the management team has the necessary talent to build a successful business, the product has a market and the market is large enough to justify the investment and, if successful, generate the targeted rate of return.

**Who Is the Decision-Maker?**

If knowing your audience is important to knowing how to tailor the presentation of the business, *the issue of knowing who makes the decision within the investing entity or investment bank is critical.* Nearly all venture and private equity investors have investment committees that ultimately determine if the firm will make an investment. The committee may rely on the recommendation of a senior analyst or junior partner, but the concurrence of one or more of the general partners is usually required to make a
preliminary funding commitment. The question is a little more complicated in the case of investment banking firms. Is the decision maker the banker, the analyst, the senior executive officer, or some combination of these? Here are some guidelines:

• The larger the size of the investment banking firm, the greater the likelihood that the firm maintains a Commitment Committee. Typically comprised of the senior executive officers, senior bankers and sometimes an analyst or two, the Commitment Committee is vested with the responsibility to evaluate funding opportunities and determine if the firm will proceed to issuing a letter of intent. Within firms that maintain such committees, the Commitment Committee is the ultimate decision maker with respect to the investment banking firm agreeing to underwrite or co-underwrite public offerings and agreeing to undertake a private placement on a best efforts basis. In firms that maintain a Commitment Committee, the banker(s) and the analyst(s) that meet with the management team and have reviewed the business plan will usually prepare a written summary of the corporation’s business and an oral presentation for the Commitment Committee that is designed to explain why the investment banking firm should proceed with the funding and on what basis the firm should do so.

• Most smaller to mid-sized investment banking firms that do not have a Commitment Committee will vest decision making authority in the chief executive officer and/or the president of the firm, although a few firms permit the officer who heads up the corporate finance department to make the decision to issue a letter of intent. In these cases, the senior executive in corporate finance is generally required to obtain approval of the chief executive officer and/or the president before the letter of intent is delivered to the corporation.

• The function of the chief executive officer or the Commitment Committee is to carefully review the valuation analysis that has been done, consider input from the analyst(s) and analyze the terms of the offering to ensure that the compensation payable to the firm is in accordance with acceptable norms. This is particularly important to firms that are involved in a number of public offerings given the fact that investment banking compensation is public information once the compensation is disclosed in a registration statement or amendment that is filed with the SEC. Since other investment bankers, professionals, and management teams of small businesses will often review prior offerings to ascertain what compensation the firm is being paid in similar transactions, most investment bankers will pay close attention to any compensation disclosure and when it is made. For this reason, some firms will insist that the underwriting discount (otherwise referred to as the commission) and any nonaccountable expense allowance or success fee
is only disclosed in an amendment to the registration statement once the NASD has approved the underwriting terms and arrangements.

• The passage of Regulation FD and increased attention being devoted to analyst's compensation for investment banking business they assist in bringing the firm has greatly increased the scrutiny of analysts by investors and regulators. Many recent articles have questioned analysts' independence and their motivations for issuing favorable research reports. Nonetheless, in the larger regional and national investment banking firms, the analyst should always be viewed by the management team of the small business as one of the key players, if not the key player, in the decision to present the funding opportunity to the Commitment Committee. Some investment banking firms have formal or informal policies that require at least one analyst to agree that he/she will provide research coverage on the small business on a post-offering basis before the Commitment Committee will issue a letter of intent. Even those firms without such policies have a vital and continuing interest in assuring that either an analyst within the firm, or an outside analyst, will provide coverage. This is particularly true because some institutional investors will not purchase a small business's securities in the public market unless the corporation has secured research coverage from at least one investment banking firm or independent analyst. The importance of the analyst in the commitment process should therefore never be underestimated.

THE NEXT STEP: INTERVIEWS AND DUE DILIGENCE

Once an investor or investment banking firm has received the business plan and completed its initial reviews, those plans deemed meritorious of further investigation are usually forwarded to a senior level executive and reviewed by an analyst. Again, this review will often be focused on the metrics and assumptions used in the projections and on whether the projections are reasonable. If the business is in the operating or mature stage, the investor or investment banker will also carefully review and consider the management team's experience and background. Since many investors and investment bankers are of the view that "you bet on the jockey, not the horse," the makeup of the management team may be critical to whether the decision is made to proceed to the next step.

At this point, most investors will ask for a face-to-face meeting with the management team to obtain answers to their questions and make an evaluation of the management team's general level of competence. In some cases the investor may have performed limited background checks or made an attempt to contact prior employers or investors to gain some insight into
management's experience and style. Often, however, the background checks are deferred until after one or two meetings that indicate to the investor if the opportunity is worth pursuing.

If the small business is being presented to an investment banker, many bankers will initiate contact with a conference call to ask many of the same questions that an investor might pose in a first meeting. Investment bankers often will seek an in-person meeting if the conference call results in additional interest. The in-person meeting is usually an exploratory session that the banker uses to cover questions about the corporation's business, operations, management, and financial results. Investment bankers and investors may also be interested in management's judgment of the greatest risks that the business faces in achieving success. This is a common question that, more than anything else, is designed to test management's knowledge and judgment of the business and the obstacles that may interfere with the corporation achieving its projected results.

Because both investors and investment bankers condition even their preliminary commitments on the satisfactory completion of due diligence, it is fair to say that most investors and bankers don't conduct a significant amount of due diligence at this stage in the financing process. It is also true that investors are inclined to conduct more due diligence than bankers due to, among other reasons, most investors' reluctance to even issue a preliminary commitment without having reached at least a moderate level of comfort. Depending on the attractiveness of the opportunity and whether the investor senses, or knows, that discussions are ongoing with other potential investors, the amount of due diligence performed before the issuance of the preliminary commitment may be curtailed. Perhaps a good general rule here is that the amount of due diligence will likely vary by business type, stage of development, financial needs, management credibility and experience, and other factors deemed significant by the investor.

Most business plans do not include confidential information about the corporation's business, its technologies or its products due to the wide dissemination of the plan among prospective investors and bankers. The commencement of due diligence is generally the point in time when investors and investment bankers may have, or request, access to confidential information. This will require the management team to have retained counsel to prepare a confidentiality agreement to ensure, to the extent possible, that any confidential information that is disclosed remains confidential. Confidentiality agreements should generally cover the following:

- A broad definition of confidential information, including all written materials furnished by the corporation, oral discussions, and studies or reports prepared by the investor that reference confidential information;
The duration of the confidentiality obligation, generally from one year to two years;
• Early release provisions that are triggered once an authorized disclosure of information has taken place;
• Nonsolicitation clauses that prohibit the solicitation of the corporation’s employees, customers or suppliers for specified periods of time;
• Restrictions on the use of information disclosed in the contemplated financing transaction;
• Confirmation that the information is furnished “as is” and is without representation or warranty;
• Obligations to return all confidential information if the financing transaction is not pursued;
• References to remedies if the confidentiality agreement is violated;
• Disclaimers of any agreement between the parties unless and until definitive agreements are executed; and
• For those corporations that are public, a “standstill” clause that provides the investor will not engage or participate in any kind of proxy solicitation, hostile tender offer, or other transaction in which control of the corporation may be at issue.

Experienced investors and investment bankers are accustomed to executing confidentiality agreements with these or similar provisions. The small business must still be alert, however, to the fact that an investor may have an interest in a portfolio company that may be a direct or indirect competitor to the small business and, therefore, may have a conflict of interest that could preclude or affect its investment in the small business.

**Practice Tip.** Once negotiations with a prospective investor or investment banker get serious, the most significant issues that will be covered in the term sheet or letter of intent will have been raised by the investor or banker, if not by the corporation. This will occur prior to the issuance of the term sheet or letter of intent. The reasons for this are, from the investor’s or banker’s perspective: (1) to obtain some assurance that, if a term sheet or letter of intent is issued, the parties are at least “in the same ballpark” and have a chance of reaching a preliminary agreement, and (2) to seek at least a moral commitment (that will be in writing in the term sheet or letter of intent) that the small business will not “shop” the term sheet or letter of intent with other investors or bankers in an effort to obtain more favorable terms.

The following issues are those typically considered to be significant in this context by investors and investment bankers.
The following is a brief overview of these issues.

**Valuation**

For either investors or bankers, this is the defining issue. The investor will be focused on determining a current enterprise value that represents a discount to future value calculated from the projections using various valuation methods. The investor will construct financial models designed to examine different scenarios under which the targeted annual rate of return is realized or exceeded. The investment banker will perform the valuation analysis described in Chapter 3, primarily relying on valuation comps of similar businesses, to arrive at a current enterprise value that is then discounted by some small amount to "leave something on the table" for the public or private placement investors.

**Rank/Structure**

The venture or private equity investor is usually quite concerned about limiting, to the extent possible, downside risk. This is typically accomplished by structuring the investment using debt or preferred stock instruments that provide the investor a rank senior to the common stockholders in the event of liquidation or distributions. The structure of the financing will also encompass rights/obligations to provide further financing, dilution in subsequent rounds, and acceptable levels of equity equivalents in the form of options and warrants.

**Compensation**

Investment bankers will want to have some understanding as to their compensation before committing to the transaction in writing. Again, the underwriting discount (commission), nonaccountable expense allowance or success fee, and warrants to purchase the corporation's stock are the most common form of compensation for bankers. Although NASD Regulation is responsible for regulating investment banking compensation in public offerings, compensation for bankers in private placements is not subject to regulation and is therefore more susceptible to wide variations.

**Salability**

The venture or private equity investor will have considerable interest in assuring that the securities purchased will be transferable and salable into
a public market once the corporation becomes a reporting company. Thus, conversion and registration rights, as well as redemption obligations, will be highly relevant to the investor.

**Future Dilution**

The investment banker will want to understand the existence of any convertible instruments, such as those held by venture or private equity investors, as well as instruments such as options, warrants, or rights that are exercisable to purchase common stock. To the extent these instruments are outstanding, the investment banker will examine their dilutive effect on earnings and enterprise valuation and may seek to limit their future issuance.

**Liquidity Events/Liquidity/Lock-ups for Insiders**

Venture and private equity investors will want assurances that customary liquidity events such as sale of all or a portion of the business, public offerings, or sales by controlling shareholders, will offer the investors a liquidity window. Similarly, in the public offering setting, the investment banker will want to understand the liquidity needs/wants of the insiders, if any, and will have in mind a lock-up period for the insiders.

**The Term Sheet**

Once the venture or private equity investor is comfortable that the financing opportunity is an advantageous one and that the principal investment terms have been addressed or committed to, the next step is for the investor to prepare, deliver, and negotiate the term sheet. A term sheet is similar in substance to a letter of intent, but usually defines the principal terms of the investment in a brief, more summary format.

Appendix A, “Sample Term Sheet for Preferred Stock Purchase by Venture or Private Equity Investor,” is a very good example of the types of term sheets used by venture and private equity investors. This term sheet covers all of the significant investment terms referred to above as well a number of related issues. A few points are worthy of mention with regard to this type of term sheet:

- Capital structure is carefully described to encompass issued capital stock, options outstanding, and the available pool of options from which the corporation may issue additional options.
- Corporate governance is addressed in several portions of the term sheet, including board membership, employment agreements, key man life insurance, committee membership, minimum numbers of meetings, and votes required to modify charter documents or any of the investment documents.
• The term sheet will often require the corporation to pay some type of deposit to the investor to defray the investor's legal expenses and out-of-pocket due diligence costs.

Appendix C, “Senior Subordinated Debt (Mezzanine) Term Sheet,” is a different form of term sheet used by mezzanine lenders to describe the terms of a senior subordinated loan to a public company. This type of term sheet, as opposed to the form of term sheet used by venture capital firms to describe preferred stock investments in early stage entities, is generally shorter and offers fewer protections for the investor. Key points in this type of term sheet include:

• A higher rank and liquidation preference over any other junior debt, but subordination to the senior bank debt;
• A higher coupon than is paid by early stage entities, but warrants that will purchase a significantly lower percentage of the ownership interest of the corporation than most preferred stock investments will buy;
• No board representation and no provision for price anti-dilution;
• Provisions for an early redemption of the senior subordinated debt at the earlier of five years from closing or from proceeds of a follow-on equity offering;
• Covenants that restrict the ability of the corporation to enter into certain transactions, pay dividends, incur additional senior debt, or redeem common stock without consent of the holder of the subordinated debt;
• Reporting obligations to the holder of the subordinated debt consistent with reports that are provided to the senior lender; and
• A right of first refusal to purchase sub debt and/or attached warrants on transfer.

Appendix D, “Senior Credit Facility Preliminary Term Sheet,” is a sample term sheet for a senior bank credit facility that incorporates both a term loan and revolver extended to a small business. Key points include the following:

• A five-year term for both the term loan and revolver, but principal amortization of the term loan commences immediately and extends through the five-year term for 30% of the total principal amount;
• Use of the term loan proceeds to finance an acquisition, with the remainder being subject to escrow and released on receipt by the corporation of additional equity funding or on certain financial objectives being met;
• Revolver draws based on eligible accounts receivable and inventory;
• Two interest rate options, including the bank's base rate and a London Inter Bank Offering Rate (LIBOR) option;
• Commitment fees for unused portions of the debt and obligations of the corporation to pay all of the bank's legal and collateral audit expenses, regardless of whether a closing occurs;
- Mandatory and voluntary prepayment provisions, including mandatory prepayments using all "excess cash flow" (as defined); and
- Indemnification of the lenders and provisions regarding the right of the lenders to participate out or assign all or a portion of the loans.

The sample term sheets in Appendices A, C, and D are typical of the types of term sheets that are frequently used by venture and private equity investors, mezzanine lenders, and senior bank lenders. Although the form of term sheet may vary somewhat from transaction to transaction, a review of these Appendices should prepare the small business and its advisors for what it will usually encounter when negotiating with these investors and lenders. If the corporation is negotiating smaller bank loans or equipment leases, management will often find that these transactions are prepared on short form documents that require, and permit, little in the way of negotiations. Since the corporation generally prepares investment documents for founders and angel investors, management will usually dictate the form of these documents. The following section addresses letters of intent and retention agreements regarding retail and institutional private placements and public offerings.

**LETTERS OF INTENT AND INVESTMENT BANKING AGREEMENTS**

Appendix E, "IPO Letter of Intent," and Appendix F, "Follow-On Public Offering Letter of Intent," are typical of the letters of intent that may be offered by investment banking firms to corporations seeking to complete a small retail IPO or larger follow-on public offering. While investment banking firms have as many different versions of letters of intent as can be imagined, a good rule of thumb is that the larger the amount being raised, the shorter the letter of intent. The converse is also true, i.e., the smaller the amount being raised, the longer the letter of intent. One of the principal reasons for this difference is that the letter of intent that relates to a small retail public offering must address a variety of issues that generally arise only at the time of an IPO.

One of the most notable differences between Appendices E and F is the amount of compensation that will be paid to the investment banking firm(s). NASD Regulation, Inc. regulates investment banking compensation payable in connection with all equity public offerings. The regulatory scheme permits the investment banker that underwrites a small retail IPO to receive a higher percentage of offering proceeds as compensation than the underwriter of a large follow-on offering can receive. This is true for a number of reasons, but primarily reflects the fact that retail brokers must contact one investor at a time to complete sales in a small IPO and the amount purchased by each investor is typically small. A large follow-on offering, by contrast, is typically sold to institutional investors in larger
blocks by an institutional sales force and, therefore, certain efficiencies are realized in the capital raising process. Maximum compensation payable to investment bankers that underwrite small retail IPOs consists of:

- A 10% underwriting discount or commission;
- A 3% non-accountable expense allowance;
- Warrants to purchase securities equal to 10% of the securities sold in the offering, with an exercise price of at least 120% of the public offering price; and
- A consulting fee of $100,000 or more.

Investment banking firms that underwrite large follow-on offerings will usually receive underwriting discounts or commissions that range from 6% to 8% of the offering proceeds, but will not be paid a nonaccountable expense allowance or receive warrants. Letters of intent for these larger offerings will, however, typically require that the corporation pay the legal fees of counsel to the investment banker and the out-of-pocket due diligence costs of the investment banker if the offering is not successful for any reason. These fees and costs can be substantial depending on the size of the offering, how far into the offering process the corporation and the investment banker go, and the nature and extent of due diligence that must be performed.

Key points to consider when reviewing Appendix E, the small retail IPO letter of intent:

- Paragraph 1 references the number of shares to be sold in the offering, while paragraph 4(b) sets forth the pre-offering shares outstanding. By adding these numbers together and multiplying the sum by the expected offering price using the middle of the price range, the management team can calculate the “post-money” (in other words, the post-offering) valuation of the corporation that the investment banker has established. Of course, this valuation may vary if the offering is priced other than in the mid-range.

- Paragraph 2 provides standard information regarding the over-allotment option. This option allows the investment banker to sell shares that represent up to an additional 15% of the total shares sold in the offering for a period of up to 45 days after the offering.

- Paragraphs 6 and 13 describe the aggregate investment banking compensation referenced above, including the discount, nonaccountable expense allowance and underwriter’s or representative’s warrants. Note in particular the provision in paragraph 13(c) that mandates the payment of an advisory fee to the investment banking firm if the public offering is abandoned as a result of a merger, acquisition or similar transaction.

- Paragraph 14(a) describes the right of the underwriter to send an observer to board meetings who will be compensated in a manner identical to board members.
Paragraph 16 contains the underwriter's lock-up agreement under which officers, directors and shareholders agree to lock-up their shares for a nine month period after the offering. Note that the lock-up applies to derivative securities including options and common stock underlying the options.

Paragraphs 4(c) and 18(a) address the "cold comfort" letter to be delivered by the independent public accountants and the right of the underwriter to approve the audit firm.

Paragraphs 18(d)(iii) and 18(d)(iv) merely serve to reinforce the obligations of the corporation to appoint Audit and Compensation Committees of the board of directors and to have the quarterly financial statements reviewed by the audit firm.

Paragraphs 13(e), 18(f) and 21(a) make it clear that, although the offering is a "firm commitment," the underwriter has the ability to terminate its involvement at any time, without liability, for reasons relating to market conditions, due diligence, operational changes, exchange listing, and virtually any other reason imaginable. This is the reason that it is so important to do due diligence on investment banking firms when a corporation decides to proceed with an IPO.

Paragraph 20 contains a performance escrow provision under which the principal shareholder has agreed to place shares in an escrow account. The shares are released once the corporation achieves the designated financial benchmarks or at the end of seven years. The seven-year provision is vital as this provision is what prevents the early release of the shares from causing the corporation to book compensation expense. This is also the reason that forfeiture escrows are not desirable from the perspective of both the corporation and the investment banking firm, since a large loss reported from the earn-out of otherwise forfeit shares, even if attributable to noncash charges, can result in an immediate negative impact on the market for the corporation's securities. In addition, a forfeiture escrow may have income tax implications for the members of the management team that could require substantial tax payments at a time when the cash to make such payments may not be available. The principal difference between a forfeiture and performance escrow is that the terms of the performance escrow will result in the shareholder receiving his/her shares. This is offset by the fact that, from the investment banker's perspective, the failure to achieve the performance benchmarks means that the shareholder will not be able to sell or borrow against the shares until the expiration of seven years, at which time the valuation of the stock may be minimal if the corporation has not been successful or has been sold to a third party. Performance escrows are usually used to bridge a valuation gap between the investment banker and the corporation in a manner similar to the equity claw-back offered by venture and private equity firms.
The letter of intent for a large follow-on public offering in Appendix F is noteworthy for the following points:

- Paragraph 3 on page one stipulates that the underwriters will pay their roadshow expenses, subject to the later catchall that provides that the corporation will reimburse the underwriters in full for their expenses if the offering is terminated by the underwriters based on due diligence or if the corporation terminates the letter of intent for any reason.

- No price is set forth in the letter of intent, as the market price will determine the pricing of the offering. The pricing discussion in paragraph 4 indicates that the price will be set “after full consideration” of the market conditions. Most follow-on offerings are priced below the market price, although the strength of demand for the corporation’s securities will ultimately determine the pricing.

- The underwriting discount (or spread, as it is referred to in this letter of intent) is set at 7%, but note that the underwriters have indicated that it will be finalized at the time of pricing. This language is sufficiently vague that either party may have some negotiating room at the pricing conference to seek an increase or decrease in the discount.

- Assuming the offering is for a corporation listed on NYSE, AMEX, or Nasdaq’s National Market, blue sky qualifications required for state securities law compliance will not be a hurdle, but the underwriters have stipulated that the offering must be salable in sufficient states as are acceptable to them.

- This letter of intent does not reference the underwriters’ lock-up, the pre-offering capitalization of the corporation, and many of the other elements of compensation and rights that the small retail IPO letter of intent addresses. The lock-up is typically addressed in later discussions with the underwriters, and the pre-offering capitalization is typically apparent from the public filings made by the corporation. While the absence of any limitations on changes in capitalization may entitle the corporation to issue additional options or securities without approval of the underwriters, the underwriters are usually comfortable that public disclosure, together with restrictions imposed by exchange rules and tax considerations, will cause the corporation to act reasonably. The absence of many of the other restrictions outlined in the small retail IPO letter of intent is attributable to the fact that most larger investment banking firms will address issues in the course of drafting conferences and like to relate to the management team on a less formal basis that has the appearance, if not the reality, of a trust-based relationship. The management team should not, however, take this as an indication that many of the same issues will not arise through the course of the follow-on offering.
Appendix G, "Investment Banking Engagement Agreement for Institutional Placement," is an example of an engagement agreement that would be submitted to the small business when an investment banker has offered to assist the corporation in obtaining private equity or debt financing. This engagement agreement contemplates a large, institutional placement of the corporation's securities, but as previously discussed, is still on a "best efforts" basis. The key points of this engagement agreement are as follows:

• The corporation retains full discretion to accept or reject a transaction, but take note of paragraph 7(c) that imposes a break-up fee on the corporation if it terminates the services of the investment banking firm after the offering memorandum has been prepared. The break-up fee increases as the financing process proceeds and includes a "tail" in paragraph 7(d) that entitles the investment banking firm to receive its full fee if a funding transaction is concluded with an investor introduced by the investment banker within 12 months after the engagement is terminated.

• Paragraphs 1, 2, 3, and 4 describe the advisory services to be rendered and allocate responsibility to the corporation for the information used or developed by the advisor. Paragraph 5 also includes standard confidentiality provisions.

• The fee arrangements discussed in paragraphs 6 and 7 contemplate a retainer as well as a contingent fee that is calculated as a percentage of the funding received by the corporation. The contingent fee will be higher for equity and convertible debt, as opposed to the fee payable for subordinated debt. In addition, all expenses of the advisor are to be reimbursed by the corporation.

• The remainder of the engagement agreement is comprised of indemnification provisions, the right of the advisor to place tombstone ads following closing, and termination rights.

• Paragraph 9 is very important as it grants the advisor a right of first refusal to serve as a co-managing underwriter of any future public or private offering of common stock or debt if the private financing is completed. Note that the terms of such engagement are to be "customary" and that the advisor makes no commitment to provide any additional funding. Once again, as was the case in the follow-on offering letter of intent described above, the investment banking firm is seeking to establish a trust-based relationship that, if the private round is successful, will flow through to the next round of financing. This right of first refusal is a significant "carrot" for the investment banker, but may obligate the corporation to use the investment banker even if the corporation is dissatisfied with their prior performance. In certain situations, the corporation may be able to facilitate a "buy-out" of the right of first refusal between investment bankers or may be able to buy back the right.
Practice Tip. NASD Regulation will consider any payments from the corporation to an investment banking firm, including buy-outs or repurchases of rights of first refusal, to be underwriting compensation if paid "in connection with" an offering and if made within up to one year prior to the filing of a registration statement. For this reason, the corporation should consult with its counsel and the investment banker will do likewise before making any payment of this nature, which must be disclosed to NASD Regulation. Classification of such payments as underwriting compensation could require the investment banker that is leading the public offering to reduce its compensation or, in extreme cases, could result in the investment banker withdrawing from the offering. For this reason, management and its advisors must be careful about payments to finders, consultants, and others that can also be classified as "underwriting" compensation.

Summary

To progress from the point when the management team has determined that the corporation requires a capital injection to an agreement in principle, the small business must prepare a cutting edge business plan with plenty of information, graphics and color accents that will grab and hold a reader's attention. When targeted to a receptive audience that invests in, or lends to, businesses of the size and in the industry in which the small business is engaged, the plan should engender communications with the potential investor or lending institution that will lead to a term sheet, letter of intent or engagement agreement. Although none of these will guarantee funding, the fact is that most investors and lending institutions will not issue a preliminary commitment in writing unless there is a high level of interest and a minimum level of comfort with the business model. While term sheets, letters of intent, and engagement agreements come in a wide variety of forms, the appendices relating to this Chapter represent common forms that should assist the management team in evaluating documents submitted to them by potential investors or bankers.

* * * *

Case Study Hypothetical—You Are the CFO

You are employed as the CFO of Chairs To Go, Ltd., a manufacturer of chairlifts for the skiing and snowboarding resort industry. Consistent with your firm's motto, "We Put Seats in Chairs," the sales of your chairlifts have been growing at double digit rates as resorts worldwide have upgraded their chairlifts to faster and more comfortable models. The design team has come up with several new models of chairlifts, including chairs with built-in heavy duty headphones that
broadcast music and information about the resort, a high speed model that can be manufactured in miniature for use by children, and chairs with seat warmers that are guaranteed to make everyone who rides a "hotty." You and the CEO estimate that putting the manufacturing capacity in place to introduce these new lines will require capital expenditures of $10 million and operating cash reserves of an additional $2 million to pay for staffing increases necessary before expected sales will materialize. Chairs To Go is a private company but the CEO expects to either take the company public or sell in the next five years or so.

After combing through your old accounting seminar materials and rummaging about the Internet, you successfully identified several private equity groups that seemed to be good prospects to fund this expansion. You and the CEO prepared a top notch business plan and circulated it to the prospective investors and at least three firms have indicated some degree of interest. Of these three firms, one firm by the name of Big Bite Private Capital seems particularly interested and requested an in-person meeting with you and the CEO after reviewing the plan. The meeting went well and, low and behold, Big Bite forwarded to you the term sheet that is reproduced below. The CEO has asked to meet with you tomorrow to get your comments on the term sheet and your feelings as to whether or not you think Chairs To Go should seek term sheets from the other two private equity firms or try to agree on terms with Big Bite. Knowing the CEO as you do, you are anticipating that he will do as you recommend, since his strength is marketing and sales and he relies on you for financial guidance. You're on the spot!!

Chairs To Go, Ltd.

Senior Subordinated Debt
Term Sheet Submitted by Big Bite Private Capital

Issuer: Chairs to Go, Ltd. (the Company)
Type of Security: Senior Subordinated Debt (Subordinated Debt).
Issue Size: $12 million.
Use of Proceeds: To fund $10 million in capital expenditures and to fund $2 million in anticipated working capital requirements associated with introduction of new chairlift lines.
Interest on Subordinated Debt: 14% per annum, payable quarterly.
Maturity of Subordinated Debt: Earlier of (i) five years from closing or (ii) Liquidity Event (as defined below).
Warrants: Detachable warrants (Warrants), representing the right to purchase shares of the common stock.
<table>
<thead>
<tr>
<th>Clause</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maturity of Warrant</td>
<td>Earlier of (i) five years from closing or (ii) Liquidity Event (as defined below).</td>
</tr>
<tr>
<td>Liquidation Preference</td>
<td>Preference to existing common stock on liquidation plus an amount equal to the deemed value of the warrants on an as-converted basis.</td>
</tr>
<tr>
<td>Registration Rights</td>
<td>Unlimited piggy-back registration rights on registrations of the Company and other holders, subject to customary underwriter’s cutback. Three demand registration rights at the Company’s expense.</td>
</tr>
<tr>
<td>Board Representation</td>
<td>One member or observer, at Big Bite’s option.</td>
</tr>
<tr>
<td>Anti-Dilution Provisions</td>
<td>Protection for issuances of shares of stock at a price less than that equal to the price paid in the most recent sale by the Company, common stock splits, dividends, and combinations. No options, warrants or rights will be issued by the Company above 8% of the shares outstanding at closing, and all issued options, warrants, or rights will have an exercise price equal to or greater than the last sale price of the common stock.</td>
</tr>
<tr>
<td>Redemption Option</td>
<td>The Company must redeem the Subordinated Debt at par, plus accrued interest at any time upon the earlier of a secondary offering or after five years from closing. For each quarter that the Subordinated Debt remains unpaid after the five-year period has expired, Big Bite’s warrant will represent the right to acquire an additional 2% of the Company, i.e., if one quarter elapses after the five-year period, Big Bite’s warrant will purchase 22% of the total outstanding shares; if two quarters elapse after the five-year period, Big Bite’s warrant will purchase 24% of the total outstanding shares.</td>
</tr>
<tr>
<td>Restrictive Covenants</td>
<td>The Company may not, without the consent of the Subordinated Debt, so long as at least 50% of Subordinated Debt remains outstanding, (i) effect any transaction that results in a change of control in which Subordinated Debt is not paid in full; (ii) materially change the nature of the Company’s business; (iii) effect a liquidation or sale of the Company or sell all or substantially all of its assets</td>
</tr>
</tbody>
</table>
in a transaction in which the Subordinated Debt is not paid in full; (iv) amend its articles of incorporation or bylaws in a manner that would adversely affect the holder(s) of the Subordinated Debt; (v) redeem or pay any dividend or distribution on its common stock except to management upon ceasing to be employed, but only on terms acceptable to Big Bite; (vi) issue additional Subordinated Debt that is senior to Subordinated Debt; or (vii) engage in any transactions with affiliates except as otherwise contemplated by the existing documents or approved by disinterested members of the board of directors.

**Reporting Requirements:**

The Company shall provide the same standard financial reports that the Company provides to its senior lender(s) from time to time, so long as at least 50% of the Subordinated Debt remains outstanding. The Company shall have its financial statements audited by a firm acceptable to Big Bite.

**Drag-Along Rights:**

If the Board and the holders of a majority of the shares of common stock (voting as a single class) then outstanding approve a sale of the Company (an "Approved Sale"), each holder of Subordinated Debt and Warrants shall take all necessary or desirable actions in connection with the consummation of the Approved Sale as requested by the Board, the holders of a majority of the shares of common stock or the Company; provided that (i) upon the consummation of the Approved Sale, each holder of Subordinated Debt and Common Stock shall receive the same form and consideration and the same amount of consideration; (ii) if any holders of a class of common stock are given an option as to the form and amount of consideration to be received, each holder of such class of common stock shall be given the same option; and (iii) each holder of then currently exercisable rights to acquire shares of a class of common stock shall be given an opportunity to either (A) exercise such rights prior to the consummation of the Approved Sale and participate in such sale as holders of class of common stock or (B) upon the consummation of the Approved Sale, receive in exchange for such rights consideration equal to the amount determined by multiplying
(1) the same amount of consideration per share of a class of common stock received by holders of such class of common stock in connection with the Approved Sale less the exercise price per share of such class of common stock of such rights to acquire such class of common stock by (2) the number of shares of such class of common stock represented by such rights.

Transfer Restriction: The Company will have a right of first refusal to any proposed sales, transfers, or another disposition by the holder(s) of the Subordinated Debt to competitors of the Company.

Tag-Along Rights: Subject to certain limited exceptions (including in connection with public sales), each holder of Warrants (upon exercise of Warrants) shall be afforded the opportunity to participate in any sale of shares of common stock by selling shareholders up to its pro rata portion of the securities to be sold and on the same terms and conditions.

Pre-Emptive Rights: Until an IPO or an Approved Sale of the Company, each warrantholder shall have the right to purchase on a pro rata basis (based upon the number of shares of common stock held by such warrantholder on a fully-diluted and "as-exercised" basis) any securities the Company may from time to time propose to issue.

Expenses: Upon consummation of the transaction as described in this term sheet, the Company will pay the expenses of the holder(s) of Subordinated Debt for legal fees of one counsel to the holder(s) of Subordinated Debt, and out-of-pocket due diligence expenses. Such fees and expenses will not exceed $150,000. The Company shall pay a deposit of $40,000 on execution of this term sheet. The deposit will be credited against the total fees and expenses at closing.

Voting Rights: The warrantholders will vote on an as-exercised basis on each item submitted to a vote of the stockholders of the Company.

SEC Compliance: The Company will comply with the reporting obligations imposed on it by the Securities Exchange Act of 1934 after it completes its IPO, if ever.
Situational Analysis

1. Assume that the percentage of Chairs To Go that Big Bite’s warrants would purchase has a value of $3 million at the end of five years, based on the projections you have prepared. How would you explain the value of the warrants and the interest expense so that the CEO can readily understand the implications?

**Practitioner Response:** Since you know that the exercise price of the warrants is nominal, you can assume that the entire $3 million of value of the warrants is simply additional return to Big Bite. A simple way to discuss this with your CEO would be to explain that this $3 million return over the five-year exercise term of the warrants, when considered against the aggregate financing of $12 million, would equate to a return of 25% over the five-year period, or an additional 5% per year. This calculation does not, however, reflect the present value of the $3 million. That is, if the warrants have a value of $3 million at the end of the five-year period, it may be more accurate to discount the $3 million back to a present value using an acceptable discount rate. If the warrants have a present value of $2.2 million, then the real rate of return represented by the warrants in today’s dollars is approximately 18% and, when spread over the five-year period, is more like 3.6% annually. This would put the all-in cost of the financing at 17.6% in present value terms, consisting of the current interest of 14% and the 3.6% per year represented by the warrants. You should hasten to point out to the CEO that this calculation does not reflect what will happen if Chairs to Go fails to pay the subordinated debt when due, which would increase the percentage of the company (and the rate of return, assuming the debt is eventually repaid) owned by Big Bite as its warrant position increases for each quarter the debt remains unpaid.

2. Given the five year window for a Liquidity Event and your knowledge of the CEO’s plans, how would you advise him as he negotiates with Big Bite on the redemption and maturity terms?

**Practitioner Response:** Assuming the CEO’s desire to complete an IPO in year five is likely to be realized, you will need to negotiate in some flexibility on the redemption and maturity terms without agreeing to some of the more punitive aspects that are now in the Term Sheet. For example, you would want to consider negotiating for a six-year term, rather than a five-year term. Since Big Bite obviously tied the exercise period of its warrants to the term of the debt, a good negotiating strategy would be to offer an extension of the warrant exercise period in exchange for the one-year extension. You would obviously want to negotiate for the ratchet clause to take effect at the end of year six, rather than year five, to negate its effect while the loan remains outstanding and current. You could offer Big Bite a faster “ratchet” upward of their ownership percentage after year six if Chairs to Go had not repaid the debt at the end of year six.
3. What is your opinion of Big Bite's liquidation preference and anti-dilution protections? How would you cut back on their proposed rights if the CEO told you to go and negotiate with them on these points?

**Practitioner Response:** The liquidation preference is somewhat outrageous since it not only gives Big Bite the value of its subordinated debt back before the common stockholders realize any return, but includes the deemed value of the warrants on an as-converted basis. This raises several issues that would need to be explored with Big Bite, such as what date would be used to arrive at the deemed value, whether the value would be an average over a period of time, and what formula or standard would be used to calculate the deemed value. In other words, in a liquidation scenario, one could assume that the as-converted value of the warrants could be quite small if the common stock had little value. However, if the corporation was liquidated at a price well above book value, the common stock might have considerable value. The question that would need to be resolved in the term sheet or definitive agreement would be whether liquidation value would be equal to fair market value, book value, or some combination, and the means by which value would be established if not readily apparent. The anti-dilution provisions are very restrictive as to the percentage of ownership that can be issued in the form of options and the minimum exercise price. A more typical range would be 10% to 14% of the outstanding shares issuable in the form of options. Also, the minimum exercise price provision could restrict Chairs to Go's ability to grant a compensatory option to a new hire that wanted to receive options at a strike price closer to that of the current members of the management team. In negotiating these points, it would be wise to seek the right to grant additional options, even if limited on an annual basis, with some exercise price flexibility for a percentage of those options. The lower exercise price could be limited to options only for officers who are new hires, thus eliminating any concern on Big Bite's part that Chairs to Go would use this to get below market options to its existing management. Renegotiation of the liquidation value of the warrant might start at the point of insisting that Big Bite would participate in liquidation as to its warrants on an as-converted basis on the same basis as the common stockholders. That is to say, there would be no liquidation preference above the common stock (as the Term Sheet currently provides), but Big Bite would participate on an as-converted basis equal to the common stock once the senior debt and subordinated debt had been paid in full.

4. Is the transfer restriction acceptable to you? If not, why not? What about the pre-emptive rights? Again, if you were charged with cutting back the rights granted to Big Bite, what would you seek to change?
**Practitioner Response:** The transfer restriction is not acceptable because the restriction on transfer to any competitor of Chairs to Go should be absolute, rather than obligating Chairs to Go to have to buy the Subordinated Debt back by using the right of first refusal. In the hands of a less principled lender, the lender could put Chairs to Go in the uncomfortable position of either having to buy back the debt or permit its transfer to a competitor, either of which would (or could) be unacceptable. The preemptive rights are unacceptable because they are limited to the warrant holders, of which it appears Big Bite is the sole such holder. Note that the way this provision is drafted, the warrant holders would have the right to purchase their *pro rata* share of any securities issued by Chairs to Go, meaning that this could even apply to senior debt, subordinated debt, or other securities issued by Chairs to Go. It would be appropriate to seek a time limitation on these rights and a limitation to a much more narrowly defined class of securities. Alternatively, if Chairs to Go was in a good negotiating position, you might consider negotiating for an elimination of this provision altogether. If this were unattainable, the management team should at least seek to have the preemptive rights apply to the common stockholders, not just the warrant holders, so management and the other investors could participate in any subsequent rounds on the same basis as Big Bite, if they chose to do so.

5. What about the expense provision seems unusual? Would you agree to the voting rights and SEC compliance provisions? Why or why not?

**Practitioner Response:** The limitation of $150,000 on the expenses is very high in a financing of this nature. The deposit is also somewhat high. "Out-of-pocket due diligence expenses" can be used by Big Bite to recover all costs of travel, hotel, etc., for staff that they use to conduct due diligence which, if not limited, could add up to a very sizeable amount. Some would argue that the voting rights provisions are unnecessary since Big Bite's status as a lender provides it with more than enough power to approve or disapprove any material item presented to the stockholders through exercise of its powers under the restrictive covenants. This would not be an unreasonable position to take. The other way to approach this would be to require the exercise of the warrants, which would obviously give Big Bite the same rights as all the other stockholders. With a nominal exercise price, this might be acceptable to Big Bite, although tax considerations might impact when Big Bite would prefer to exercise the warrants. With respect to the SEC compliance clause, you should negotiate for a "best efforts" qualifier, rather than an absolute agreement to comply. If the definitive agreement had the language requested by Big Bite here in the Term Sheet, Big Bite would have a breach of contract action against Chairs to Go if Chairs to Go was unable to remain in compliance despite using its best efforts to do so.
6. What would you add to this term sheet that is missing? (Hint: the added provision would limit rights after a certain event occurs.)

**Practitioner Response:** The addition of a "sunset" clause that terminates many of the rights of Big Bite on conclusion of an IPO would be very appropriate to add. Since the Subordinated Debt is to be repaid on conclusion of the IPO, it would be logical to eliminate Big Bite's board representation, option restrictions, and voting rights, among other things.
CHAPTER 5

COMPLIANCE ISSUES: DISCLOSURE DOCUMENTS, DUE DILIGENCE, FINANCIAL STATEMENTS AND CURING PRIOR VIOLATIONS

The financing transactions that a small business corporation undertakes during the course of its existence are generally divisible into two broad categories: issuances of registered securities or securities exempt from registration. Registered securities are included on a registration statement that is filed with the Securities and Exchange Commission. Securities issued in exempt transactions are subject to the rules and regulations adopted by the SEC under the applicable provisions of the exemption. If the small business fails to comply with the exemption's conditions, the consequences may be severe and include, but are not limited to, civil enforcement proceedings or even criminal sanctions. Accordingly, the small business must observe strict compliance with exemption provisions, not to mention the registration requirements under applicable forms, when concluding a financing. This Chapter is intended to highlight the areas that are commonly the source of compliance difficulties, in particular those associated with financial statement requirements.

As the corporation moves through the corporate life cycle and enters into more sophisticated financing transactions, the management team will often encounter investors and investment bankers that are increasingly knowledgeable about the small business's industry and market due to their specialization in research and analysis, as well as their involvement in prior financings within the industry. These investors and bankers will also be adept at assessing the corporation's prior compliance with the registration and exemptive provisions of the securities laws. Prior noncompliance that is unearthed in the course of due diligence has significant potential to
kill a financing transaction and may force the corporation into public disclosure that is embarrassing at best or that, at worst, may trigger legal action by the SEC or private parties. While it may be tempting to stretch accounting and legal advice or perhaps ignore it altogether, the management team is well advised to pay close attention to compliance issues to reduce the chances of incurring legal liability and to avoid the necessity of later disclosure that may have an enormous negative impact on the corporation. The following discussion offers suggestions on (a) preventive measures that can be taken by the management team to reduce the chances of compliance violations, and (b) the options available to the corporation to cure prior inadvertent violations.

**DISCLOSURE DOCUMENTS**

There are a variety of documents used to provide disclosure to investors prior to the closing of a financing transaction. Without overgeneralizing, the disclosure documents can be broken down by the type of financing secured by the small business, as included in Table 5.1.

**Table 5.1 Categories and Types of Disclosure Documents**

<table>
<thead>
<tr>
<th>Type of Disclosure Document</th>
<th>Bank or Mezzanine Loan</th>
<th>VC's and private equity groups</th>
<th>Retail private placement</th>
<th>Public Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Schedules or exhibits to purchase or loan agreement</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Term sheet (abbreviated private placement memo)</td>
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<td>Private placement memorandum</td>
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<td>SB-2 registration statement</td>
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<td>S-1 registration statement</td>
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The following discussion elaborates on the information described in Table 5.1:

• Loan agreements with banks are rarely the subject of disclosure documents per se. Loan agreements that relate to larger credit facilities will often include disclosure in the form of exhibits to the loan agreement. These exhibits will most often be comprised of the following:
  — Promissory note
  — Compliance certificates that indicate compliance with debt service coverage ratios, interest coverage ratios, flow of funds coverage ratios, minimum tangible and/or book net worth, debt to tangible and/or book net worth, EBITDA, capital expenditure amounts and other financial ratios
  — Security agreements
  — Financing statements
  — UCC-1’s
  — Permitted liens
  — Permitted indebtedness
  — Guarantees
  — Capitalization chart
  — List of subsidiaries
  — List of collateral locations
  — List of officers
  — Locations at which the corporation conducts business
  — An inventory of intellectual property

The last six points above constitute disclosure provided by the corporation to the bank. As might be expected, even this disclosure is primarily focused on the location and identification of collateral for the loan that is being made.

• The corporation may furnish early stage angel investors only with a subscription agreement that contains little or no disclosure. While this is definitely not the recommended course of action, it is understandable that the early stage entity may have little in the way of documentation to furnish to the investor.

Caution. If an angel investor is willing to invest with minimal or no disclosure, the subscription agreement should provide the investor’s acknowledgment that the investor is accredited, sophisticated, able to fend for him/herself, and that the investor has been given the opportunity to conduct such due diligence as the investor desired to do. The subscription agreement should also provide that the investor had access to such documentation as existed and that officers and directors were made available to answer any questions that the investor
desired to ask. Some subscription agreements even contain indemnity clauses that obligate the investor to indemnify the corporation, its officers, and its directors from any claims related to due diligence, whether performed or not. While such a clause might not be enforceable if fraud or concealment took place, the well prepared management team may want to consider using such a clause for protection of the corporation as well as its officers and directors in circumstances where the investor elects to conduct little or no due diligence.

- Operating and later stage angel investors, together with venture and private equity investors, will typically conduct their own due diligence. This due diligence is usually completed prior to the execution of the purchase agreement. However, if due diligence is not yet completed, the investor will generally have in the purchase agreement a condition to closing that stipulates that the closing is contingent on the satisfactory completion of due diligence.

  Caution. The use of purchase agreements with “due diligence” conditions to closing can be very dangerous to the corporation. In effect, the purchase agreement becomes a one-sided commitment and the investor has a “due diligence” out from the contract. For this reason, many management teams will strongly prefer that the investor complete its due diligence before the contract is executed. This will allow the corporation to retain flexibility in the financing process, at least to the extent enjoyed by the investor, and will avoid the situation where the investor claims to have suddenly uncovered facts in the course of due diligence that merit a reduction in the valuation before closing.

The form of the typical purchase agreement with angel, venture and private equity investors, as well as mezzanine financing sources, can be divided into five parts. These are:

- Terms of the investment;
- Representations and warranties;
- Covenants and negative covenants;
- Indemnities; and
- Miscellaneous provisions.

The investor’s own conduct of due diligence does not mean that the corporation is not required to make disclosures to the investor. Rather, what this means is that the investor will be asking for the corporation to make unqualified representations and warranties and, whenever there is an exception to the representation or warranty, the exception must be included as a schedule or exhibit to the purchase agreement. The corporation must carefully review each representation and warranty and, if there is an exception, it is imperative that the management team provides full and appropriate disclosure of the exception.
Appendix H, “Series A Preferred Stock Purchase Agreement,” is a purchase agreement that is typical of the form used by venture and private equity investors. In addition to having a schedule of exceptions to the representations and warranties provided to the investor, the purchase agreement has each of the categories described above except indemnities, which have been included in a separate agreement that is itself an exhibit to the purchase agreement. The investors’ rights agreement and the stockholder agreement that are also exhibits to the purchase agreement are discussed later in these materials.

Unlike some term sheets and full-blown private placement memorandums, the disclosure required in a purchase agreement such as that in Appendix H is driven more by the requirements of the contract, rather than the applicable provisions of the securities laws. This is not to say, however, that an investor that is party to a purchase agreement is not entitled to the benefits of disclosure mandated by law. Rather, the corporation is relying on Section 4(2) of the Securities Act for an exemption from the registration requirements of the Act and Section 4(2) contains no specific informational requirements for the disclosure to be delivered to investors. Hence, the investors will use the terms of the contract to specify what information has been supplied (in the forms of representations and warranties and exceptions to the representations and warranties). Even though the contract specifies the disclosure required, the corporation is still subject to the anti-fraud requirements of the securities laws. Accordingly, if the corporation’s representations and warranties are correct and true, but the corporation has omitted to disclose information to the investor that would be material to the investor’s investment decision, the investor could still seek rescission of its investment or damages for the corporation’s failure to comply with the anti-fraud rules.

There are several key provisions in purchase agreements with investors that relate to due diligence and the disclosure obligations of the corporation:

- Note in the introduction to Section 3, entitled “Representations and Warranties of the Company,” that the Schedule of Exceptions must reference each individual representation and warranty to which it relates. In other words, blanket exceptions are not permitted!
- The introduction also states that “the Schedule of Exceptions accurately states in all material respects” the exception. Also, if the exception relates to a representation or warranty that includes a materiality threshold amount, the exception has to include an estimate of the amount that is in excess of the materiality threshold. This forces the corporation to estimate its liability for amounts that are in excess of a materiality threshold when an exception is cited.
- Section 3.4 addresses the financial statements that, in this instance, were unaudited.
The exception from GAAP is noted due to the absence of financial statement footnotes. Had the financial statements been audited, the representations and warranties in this section of the purchase agreement would have covered such issues as:

- The independence of the audit firm;
- The fact that the audited financial statements fairly present the financial position and results of operations of the corporation;
- The statements were prepared in accordance with GAAP consistently applied except as otherwise stated therein;
- Representations that the corporation's system of internal accounting controls is sufficient to provide reasonable assurances that (i) transactions are executed in accordance with management's specific or general authorizations, (ii) transactions are recorded as necessary to permit the financial statements to be prepared in accordance with GAAP, (iii) accountability for assets is maintained, and (iv) recorded accountability for assets is compared with existing assets at reasonable intervals and differences are addressed; and
- Any comfort letter required to be delivered as a condition of closing has been delivered in a form acceptable to the investor.

Section 3.18 states the corporation is relying on Section 4(2) of the Securities Act for an exemption from registration, and states further that the corporation has not solicited offers or sales that would have required registration. This section of the purchase agreement is important due to its recitation of the exemption being relied upon, which further supports an investor's case that it is entitled to the benefits of the law, including the anti-fraud rules, not just the contract.

Section 3.19, "Full Disclosure" is perhaps one of the most important provisions in the purchase agreement. This section indicates that the corporation has complied with the standards of disclosure set forth in Rule 10-b(5) of the Securities Act ("...do not contain any untrue statements of material fact nor omit to state a material fact..."). Again, this section merely recites the provisions of the law applicable to the sale of the securities, but by including this section in the purchase agreement, the investor has created a contractual right, rather than merely a right under applicable law, to receipt of this disclosure. If the corporation fails to abide by this disclosure standard, the corporation may face securities claims as well as breach of contract claims, due to the inclusion of this section in the contract.

Note the language in Section 5.1(m) that provides a "due diligence" out of the contract based upon the purchasers having completed their pre-investment review to their satisfaction. As much as this corporation sought to have this provision removed from the contract, it was unsuccessful in doing so!
Sophisticated investors will often include provisions in the purchase agreement that provide substantially as follows:

>The due diligence review and investigation conducted by Investor shall not affect or otherwise diminish or obviate in any respect any of the representations or warranties of the Corporation in this Agreement.

This language is extremely important in that it may deprive the corporation and the management team of a prospective “due diligence” defense to any claims brought by the investor. It is difficult to accept this language, particularly if the management team has witnessed the investor and its counsel conducting massive, and expensive, due diligence for which the corporation will be billed. On the other hand, the sophisticated investor will probably indicate that they have this language in each of their purchase agreements and that the corporation should have no difficulty with the language if it has provided the investor with full disclosure.

Practice Tip. When faced with a sophisticated investor who seeks provisions in the purchase agreement such as that described above, the management team should not panic or run for the nearest alternative investor. Since many institutional investors operate in a similar manner, the best thing for the management team to do is adopt a two-pronged plan: Disclose and Qualify.

Rule Number 1: “Disclose.”

The management team should carefully review, in conjunction with the corporation’s professionals, any questionable disclosure issues and/or issues that arose in due diligence. If a judgment must be made about disclosure, the corporation should err on the side of disclosure to ensure that the investor is not given a prospective cause of action for rescission or damages.

Rule Number 2: “Qualify.”

Counsel to the investor or investment banker nearly always prepares the purchase agreement. It is not the job of the investor, the investment banker or counsel to an investor or investment banker to look out for the corporation’s interests. As a result, the purchase agreement will often lack the types of qualifications that must be placed in the purchase agreement for the protection of the corporation and to provide a sense of balance or fairness to the document. Qualifying representations, warranties and covenants is a crucial step to reaching an equitable and fair purchase agreement. The management team, assisted by counsel, should consider the language of each representation and warranty and determine where this language can be qualified. Typical qualifiers include language such as “To the best of the corporation’s knowledge...” “known to the corpora-
tion...,” “in all material respects...,” “is not reasonably expected to have a material adverse effect...,” “will result in any material obligation...” and similar expressions. While the use of the knowledge or materiality qualifiers may seem like hair splitting, the use of these terms may make the difference between legal action against the corporation or no legal action being filed.

• For placements to a small number of sophisticated and accredited individual investors who are able to fend for themselves, the corporation may consider using an abbreviated private placement memorandum, sometimes referred to as a term sheet, to provide disclosure to the prospective investors. This “term sheet” is not merely the recitation of the terms of the investment that was discussed previously, but rather represents a truncated version of a full-blown private placement memorandum. This type of term sheet will frequently include:
  — An introductory section that discusses the investment terms and summarizes the business of the corporation;
  — A complete risk factors section that outlines the risks the business has and is expected to encounter, as well as risks associated with the securities offered;
  — A summary dilution discussion that focuses on the ownership percentages, rather than net tangible book value, of the existing shareholders and prospective investors;
  — A brief discussion of the nature of the business, competition, strategy, and existing operations;
  — Biographies for the executive officers and directors;
  — A description of the securities being offered, and any compensation being paid to investment banking firms or placement agents; and
  — Historical financial information.

Practice Tip and Caution. One of the most common issues that arises in the context of this type of term sheet, as well as in the context of full-blown private placements, is the question of whether or not to furnish projected financial information to prospective investors. Legal counsel will almost invariably instruct the client that projections should not be furnished to investors. This advice is sound legal advice based on the possibility that the client will be subject to later legal action if the projected financial results are not achieved. The theory underlying this type of action is that the corporation furnished projections that it knew, or should have known, were incapable of being achieved, and that the investor relied on the projections in making its investment decision. Many early and operating stage small businesses, in particular, find their counsel's legal advice difficult to follow because of the practical difficulties associated with the corporation not furnishing projections to prospective investors. In essence, the management teams of these corporations
subscribe to the theory that an investor will purchase the securities only if the investor has some idea of what the expected financial performance of the corporation will be in future periods. Without projections, the investor is in the dark about whether the valuation established by the corporation is reasonable, whether management has used reasonable assumptions in establishing the projections (and the valuation), and what rate of return can be expected on the investment. Without projections, the conscientious investor would have to develop its own projections and attempt to "back into" the valuation set by the corporation in order to address some or all of these issues. It is rare to find individual investors who will undertake this kind of work to justify an investment.

Members of the management team are therefore caught on the horns of a dilemma: if they furnish the investor with projections, they may be liable for failing to achieve the projected results, but if they choose not to, the investor may decline to make the investment. Most small businesses take the practical, if risky, approach of supplying projections to investors. Corporations that do so should seek legal advice to assist the management team in developing a series of disclaimers to be attached to the projections that, in the strongest possible terms, advise the investor NOT to rely on the projections in making the investment decision. A risk factor should also be included in the disclosure that is consistent with the series of disclaimers on the projections. Management may also want to consider the possibility of discounting its internal projections by some percentage before furnishing projections to prospective investors. Building in a safety net might result in investors seeking a lower valuation, but may also provide some additional measure of protection from the "failure to achieve" argument.

**Practice Tip.** If the corporation is seeking investors using a term sheet as a disclosure document, counsel should also be consulted with respect to (i) what exemption the corporation will rely on when offering and selling the securities, and (ii) what conditions attach to that exemption. For example, if the corporation is going to rely on Section 4(2) for its exemption from the registration requirements, the corporation will be limited in the number of offers and sales it can make before it may be deemed to have engaged in a public offering. Alternatively, if the corporation is relying on Rule 504 under Regulation D, the offering cannot exceed $1 million in amount. Some states may have more restrictive conditions attached to their exemptions than the federal securities laws. Management and counsel will need to analyze:

- Where offers and sales of the securities are expected to be, or are, made;
- The size of the offering;
- The status of the investors (sophisticated, accredited or neither);
- The expected number of each type of investor; and
- The other conditions that may apply to an exemption.
This analysis is necessary to assure that the corporation is in compliance with the law when offering and selling securities. As shown below, when a private placement (using whatever disclosure document) exceeds certain dollar limitations or is offered to non-accredited investors, specific disclosure requirements may apply to the information that is furnished to investors.

Caution: Occasionally, a management team will ask—why do I care about compliance? As long as the investor comes out with a return on his/her investment, what does this matter? Unless the SEC finds out because someone complains, isn't this going to be a non-issue? The answer, of course, is that strict compliance with the terms of the exemption is required or the corporation may be found to have violated the registration requirements of Section 5 of the Securities Act. If the corporation violated Section 5 in a private placement because it did not comply with the terms of the exemption, this failure may require the corporation to disclose in the prospectus for its IPO that it has potential rescission liability to investors who purchased in the private placement. Alternatively, the investment banker for the IPO may require the corporation to conduct a rescission offer in which investors are offered the opportunity to receive a return of their investment dollars in exchange for their shares. In either instance, the corporation that fails to strictly comply with the terms of an exemption may not suffer any immediate harm, but may have created a long-term problem that can only be fixed by the expenditure of an enormous amount of time, effort and resources. This is why the management team MUST care about compliance.

Management and counsel must also be aware of the following compliance issues.

1. If the corporation is preparing a complete private placement memorandum, the contents of the memorandum will be governed by the disclosure rules that apply under the specific exemption that will be relied upon by the corporation. In most private fundings, a corporation will rely on one of the following four exemptions from the registration requirements of the Securities Act of 1933:
   - Section 4(2)
   - Rule 504 under Regulation D
   - Rule 505 under Regulation D
   - Rule 506 under Regulation D

2. Section 4(2) provides that an issuer of securities may make offers and sales of securities that do not “involve any public offering.” This exemption is sometimes referred to as the “non-public offering” exemption. In Release No. 33-4552, the SEC stated that this exemption is typically utilized in connection with bank loan transactions, private placements with institutional investors and with a few “closely related” persons.
Chapter 5: Compliance Issues

An interesting sidelight to the Section 4(2) exemption is that nowhere in the Securities Act is the term "public offering" defined. Therefore, when a corporation relies on Section 4(2) for an exemption, the question of whether or not a "public offering" has taken place becomes a facts and circumstances inquiry. In one if its earliest releases, the SEC stated that it would look at, among other factors, the number of offerees and their relationship to each other and the corporation, the number of securities offered, and the size and manner of the offering when considering if the corporation can rely on Section 4(2) for an exemption. The SEC focuses on whether or not the investors purchasing the security need the full disclosure required by the Securities Act to make an informed investment decision. The answer to this question, and the analysis of the facts and circumstances of the offers and sales, is best confined to qualified counsel who can undertake a dispassionate and independent review of the factors before sales are consummated that would otherwise expose the corporation to liability.

**Practice Tip.** Many companies that offer and sell securities pursuant to a private placement memorandum will disclose in the memorandum that they are relying on both the Section 4(2) exemption as well as another exemption such as Rule 506. This is acceptable, and in fact preferable, in those situations where the corporation might wish to claim the benefit of the Section 4(2) exemption if there exists a possibility that the corporation might not meet the specific disclosure or offering limitations that apply under Rule 506. The corporation's failure to meet the specific requirements of Rule 506 (or any other exemption) will not raise a presumption that the Section 4(2) exemption is not available. As a result, many issuers will cite Section 4(2) as one of the exemptions to be relied upon when conducting a private placement.

**Rule 504 and the general conditions applicable to it:**

- Permit a corporation to make offers and sales to an unlimited number of offerees and purchasers of its securities so long as the amount raised does not exceed $1 million.
- Provide that offers and sales made more than six months before or more than six months after the exempt offering are not counted toward the $1 million limitation so long as there are no additional sales during such six month periods (excluding employee benefit plans).
- Apply to offers and sales of securities by companies that are not
  — Reporting companies under the 1934 Act,
  — Investment companies, and
  — Blind pool companies.
- Require that the corporation not engage in any general solicitation or advertising unless the offering is registered in a state or states that permit registered Rule 504 offerings or unless sales are made solely to accredited investors in states that permit general solicitation or advertising.
• Do not require any specific information be furnished to purchasers.

**Practice Tip.** Occasionally the well informed client will ask why the corporation should prepare a private placement memorandum relating to an offering that does not exceed $1 million when Rule 504 states that no specific disclosure is required. The answer, of course, is that the anti-fraud rules still apply and, to the extent that material facts are undisclosed or misrepresented, the sale of securities to an investor may create a right of rescission or to receive damages.

Rule 505 and the general conditions applicable to it provide an exemption for the sale of up to $5 million in securities, subject to the following:

• The same prohibition on sales during the six months before and after the exempt offering as is described under Rule 504;
• No more than 35 purchasers (excluding accredited investors; note that special rules apply to entities and whether they count as one purchaser);
• No general solicitation or advertising by the issuer;
• Excludes offerings by investment companies; and
• If sales are made to non-accredited investors, the issuer must deliver to those investors (and for anti-fraud compliance, should deliver the same information to accredited investors) specific disclosure and financial statements that are described below.

**Practice Tip.** What is an *accredited investor*? Generally speaking, an accredited investor is:

— A bank, brokerage firm, business development company, investment company, or employee benefit plan or trust with assets exceeding $5 million;
— A natural person with a net worth of over $1 million or a joint net worth with that person’s spouse of over $1 million;
— A natural person who had individual income of over $200,000 in each of the last two years, or joint income with a spouse of over $300,000 for the most recent two years, and who reasonably expects to reach that income level in the current year; and
— Any entity in which the equity owners are accredited.

Rule 506 is similar in most material respects to Rule 505, except that Rule 506 has no upper limitation on the amount being raised. Also, Rule 506 requires non-accredited purchasers to have sufficient knowledge and experience in financial or business matters so as to be capable of evaluating the merits and risks of the proposed investment (or to use a purchaser representative that meets these criteria). The wording of Rule 506 is somewhat more favorable to an issuer than Rule 505 because offers and sales in compliance with Rule 506 are “deemed to be transactions not involving a public offering within the meaning of Section 4(2)” of the Securities Act. As dis-
cussed above, many issuers rely on both Section 4(2) and Rule 506 when offering securities in an effort to avail themselves of the "safe harbor" under Rule 506, as well as to provide some "backup" exemptive protection in case there is some inadvertent violation of the requirements of Rule 506.

WHAT SPECIFIC DISCLOSURE MUST BE PROVIDED IN THE MEMORANDUM FOR A PRIVATE OFFERING EXEMPT UNDER RULE 505 OR 506?

Specific disclosure and financial statements that must be delivered to investors are described below.

- For nonfinancial information, the corporation must provide the same information it would provide in a registration statement that it is eligible to use (e.g., if the corporation were a small business, it would provide the information required by Form SB-2, rather than S-1). The one exception to this is that if the corporation is eligible to use Regulation A, it can provide the information required by Part II of Form 1-A.

- For financial statement information, a nonpublic domestic corporation must provide the following:
  - For offerings of up to $2 million, the corporation must provide the financial information required by Item 310 of Regulation SB, except that the balance sheet must be audited to within 120 days of the start of the offering;
  - For offerings up to $7.5 million, the financial statements must be equivalent to those contained in an SB-2 registration statement; and
  - For offerings over $7.5 million, the financial statements must be in the form required in a registration statement that the corporation is entitled to file with the SEC.

All of the foregoing information must be provided to the investor at a reasonable time prior to the sale.

Note. The rules pertaining to Rules 505 and 506 offerings do have a provision that permits the corporation to deliver only an audited balance sheet dated within 120 days of the start of the offering if obtaining complete audited financial statements would result in unreasonable effort or expense. Reliance on this provision should be avoided for obvious reasons, including the likelihood that a determination of what is unreasonable effort or expense is likely to be challenged if the corporation is unsuccessful and the investor stands to lose his or her investment.

Practice Tip. Regulation D also provides that the corporation is not required to provide any of the foregoing information if sales are made only to accredited investors.
Typical Compliance Violations in Private Offerings

The most common compliance violations in private offerings occur in three categories: first, providing inadequate or incomplete disclosure to investors; second, the making of sales to non-accredited investors in “accredited investor only” offerings; and third, sales in violation of state blue sky laws. Although other violations can occur, these are the most common issues that generally surface when a sophisticated investor, investment banker, or regulator delves into the corporation’s prior financings.

Inadequate or Incomplete Disclosure

While this issue is usually entity-specific, the corporation can avoid many of the problems caused by inadequate or incomplete disclosure by using qualified counsel and auditors to review proposed disclosure and revise as necessary. This process may be time consuming and more expensive than “home grown” disclosure, but the benefits are obvious when counsel and auditors are acting as “gatekeepers” to ensure that the offering materials comply with the applicable rule. In particular, when an abbreviated memorandum or term sheet is used, the counsel and auditors will be responsible for determining the scope of necessary disclosure and assuring that the truncated disclosure still complies with the applicable disclosure standards. In those instances where a complete private placement memorandum is being prepared, the use of qualified counsel and auditors is particularly important if the corporation’s securities are intended to be sold in so-called “merit review” states where regulators review and comment upon the proposed form of disclosure.

Most “merit review” state regulators have a well-developed sense of what a private placement memorandum should include, not to mention familiarity with applicable rules and regulations. The presence of opinions of qualified counsel and auditors within a well-prepared document that demonstrates full disclosure and compliance with applicable disclosure standards will have a positive impact on the reviewer at the state level and may, in fact, result in shorter review and turnaround times. Although the SEC does not review private offering materials prior to, or during, a private offering, the Staff at the Commission will occasionally request a copy of prior disclosure documents at the time that a corporation files a registration statement for its IPO. Again, the ability to furnish the Staff with well-prepared disclosure documents will create a positive impact on the Staff’s perception of the corporation and its prior fund-raising activities.

Sales to Non-Accredited Investors in “Accredited Investor Only” Offerings

This issue most often arises when a corporation makes sales of securities in reliance on Rule 505 or 506 in accredited investor only offerings. As ref-
Chapter 5: Compliance Issues

erenced above, the specific disclosure requirements of Rules 505 and 506 do not apply if the corporation sells its securities only to accredited investors. If sales are made to non-accredited investors, the specific disclosure must have been provided or the corporation will clearly have failed to comply with the terms of Rule 505 or 506. Accordingly, when a corporation is making sales of securities in an accredited investor only offering, it is imperative that the management team and counsel review subscription agreements and ensure that the investors meet the applicable accredited investor criteria before the subscription is accepted or a closing occurs.

Regulation D does indicate that an insignificant failure to comply with the terms of an exemption thereunder does not deprive the corporation of the benefit of the exemption. Regulation D also states that only “a good faith and reasonable attempt” is required to comply with the applicable Rule. In the context of sales to a non-accredited investor, it is likely that if the corporation had in its possession a subscription agreement in which the investor had not indicated that he or she was accredited, the good faith requirement could not be met. On the other hand, the corporation is not required to hire a private detective or conduct credit searches to verify that an investor is accredited. An example that is less clear is where an investor indicates that he/she is accredited, but describes their occupation as “retired schoolteacher” or “retired,” in which case the corporation would be well advised to make some further inquiry. While “good faith” and “reasonable attempt” are not defined terms, case law has allowed courts to develop bases for finding the existence or absence of good faith or reasonableableness. Again, corporations that are engaging in a private offering should carefully review subscription documents and should discuss with counsel any purchasers about which any doubt exists as to their accredited status or, if required, their financial sophistication.

Sales in Violation of State Blue Sky Laws

Unlike the SEC, which only requires that a Form D be filed within 15 days after the first sale in an offering, state securities laws often require the filing of claims of exemption, consents to service of process and offering materials (where required) before sales are made within that state. In some states, a late or omitted filing may make an exemption unavailable, meaning that unless an alternative exemption can be identified, the corporation may have violated that state’s securities laws. Other states have provisions that permit a late, curative filing to be made, or permit a corporation to make its filing after the sale has occurred. Although many states adopted exemptions that are identical or similar to those in Regulation D, the lack of uniformity among the states as to the availability and terms of applicable exemptions means that the corporation must be very careful to consult counsel about each state in which the offer and sale of securities is expected
to be made before doing so! Given advance notice, such counsel can research the required filings, due dates, applicable fees, and alternative exemptions that may be available within a particular state, and assist the corporation in determining the appropriate means of making offers and sales and complying with any limitations that exist within that state.

**Practice Tip.** Some states have exemptive language that provides that the exemption within that state is subject to a maximum limitation in the number of offers or sales within or outside of that state. This type of exemption usually applies to small offerings to less than 10 or 15 purchasers, but may apply to larger offerings that might otherwise be exempt under federal law as described in Regulation D. While the ability to enforce a limitation outside of the state jurisdiction might be questionable, most corporations will want to be aware of any such limitations, as well as whether any alternative exemptions can be relied upon, before making offers and sales that place the corporation in the position of having lost a particular exemption in a state.

**Problems After the Fact**

Like the astronaut in space who discovers only after liftoff that a critical piece of equipment is missing, the typical problems described are often not discovered until after the fact. And, like the astronaut who has only limited means of addressing an equipment problem out in space and may now be facing a mission failure, the corporation may find itself the subject of regulatory or legal action based on prior compliance violations that may endanger a public offering or sale of the business. Too late, this prompts the management team to ask the obvious questions: Why didn’t we know about this earlier? What could we have done to prevent this? And, what do we do now?

Perhaps one context in which these issues can be examined is to note that the management team should be aware that a compliance violation may be discovered in a variety of ways. As noted earlier, due diligence teams from larger investment banking firms, and their counsel, will generally undertake a careful analysis of the corporation’s compliance with federal and state exemptions in prior offerings. Discovery may come when incomplete subscription documents, or documents that on their face contradict an available exemption, are reviewed and analyzed by these independent parties. Other means by which violations may come to light include:

- The SEC asks to see prior offering materials and something in those materials seems to contradict the corporation’s registration statement which, in Part II, must describe prior exempt offerings and the exemptions that were relied upon;
- The corporation files its registration statement with a state (as required by the registration provisions of that state’s laws pertaining to public
offerings) and the state regulators review Part II and ask whether any of the prior offerings were made in that state and, if so, the exemption that was relied upon;

- A disgruntled ex-employee or dissatisfied stockholder goes to a state regulator and complains about the corporation, and the state regulator reviews the state’s files and finds that the corporation never made any filings with respect to a prior offering in the state;
- A potential investor who is solicited to purchase securities by the corporation or a brokerage firm forwards the offering material to regulators; or
- Federal or state securities enforcement personnel that monitor offerings made over the Web and Internet chat rooms learn about an offering that seems to justify further inquiry.

These types of events take place regularly and are mentioned here to emphasize for industry personnel and practitioners that management must be informed of the fact that noncompliance might appear to be an option in a particular state or offering, but will inevitably arise in later situations that will potentially be much more harmful to the corporation. So, like our astronaut, the corporation should make sure it is fully prepared for its mission before it starts out.

**How Could the Corporation Have Avoided Compliance Violations?**

If knowledge is power, then an experienced management team that is aware of the impact of securities laws on the corporation and its future financing activities has the power to avoid missteps that may adversely impact the corporation. If a particular management team is inexperienced in these areas, the management team should secure advice from professionals who are intimately familiar with these issues. Just knowing of the typical compliance violations that are outlined above will help many management teams have a greater appreciation of the importance of compliance. In cases where state securities law issues are anticipated to arise, the corporation might even go so far as to hire local “blue sky” counsel to work with the corporation’s general counsel and assist in securing a prompt and hopefully favorable resolution of any issues that relate to the availability of an exemption in a state.

Another good rule to operate by is that “disclosure cures all.” If a corporation is undertaking a private offering and one of the officers has an old personal bankruptcy or old criminal violation that is technically not subject to disclosure, the corporation may take the position, and the professionals may concur, that disclosure is not required. The SEC and state regulators have taken the position, however, that in spite of the fact that a matter does not meet the threshold for disclosure due to time limitations or
dollar amounts, disclosure may still be required if the issue is material. Like SAB 99, the determination of materiality is not just a quantitative analysis, but requires examination of an issue from a qualitative standpoint. In those instances where materiality is not clear, the application of the “disclosure cures all” rule mandates that the corporation resolve any doubts in favor of disclosure. When applied, this rule will “cure” any disclosure violations by simply providing the information to investors and letting each investor make his/her own judgment as to whether or not to invest while in possession of the “negative” data. This removes the specter of later legal action by investors or regulators who claim that the omission of the data was intentional and negligent or even fraudulent, thus entitling investors to damages or rescission, or a regulatory agency to a civil injunction.

What to Do In Response to a Compliance Violation

Once the corporation, management team, investors or regulators become aware of a compliance violation in a prior private offering, the question is what the corporation can do in response. The context of the discovery of the violation has a great impact on available alternatives. For example, if an investment banker discovers the violation and the corporation has no imminent need for funding, the corporation might elect to make disclosure to its prior investors and merely await the expiration of the applicable statute of limitations. Most statutes of limitation on securities actions run for a one-year period from the date the investor knew, or should have known, of the violation. If the investors are informed of the problem and do not take any legal action within the allowable time, the investors will likely be barred from later asserting any claim based on a compliance violation. Alternatively, if the corporation made a sale to a single investor in a state in violation of that state’s blue sky law, and the investor’s shares could be purchased by an existing shareholder resident in another state in which the sale would have been permitted, the corporation might be able to arrange a practical solution if the investor was willing to sell his or her shares. Such a sale would not cure the original violation, but the disclosure that would then be required may be significantly more palatable to the management team.

Compliance violations are more typically discovered in scenarios where the corporation is engaged in another financing transaction and now must decide what course of action to take without causing the termination or failure of the current financing transaction. If an investment banking firm is involved in the current financing, it is a certainty that the investment banker will have a significant voice in determining what course of action the corporation will take. The other factor that will have a major influence on the action to be taken will be the nature of the violation. For example, if a compliance violation is confined to one state’s blue sky laws
and the state's regulators have indicated that the nature of the violation (e.g., the violation involved a failure to file, rather than a sale to a non-accredited investor) will in all likelihood not result in any action by the state, that violation may be cured by disclosure or, possibly, may be determined to be immaterial. Conversely, if the violation involved a failure to disclose specific information required by an exemption such as Rule 505 or Rule 506, or involved the sale of securities to a number of non-accredited purchasers that clearly exceeded applicable limitations, the alternatives open to the corporation will be much more limited. The following are the alternatives that must be considered in the presence of more serious compliance or disclosure violations:

- **Private rescission offer**—A private rescission offer is merely a private offering to previous investors informing them of all material information surrounding the compliance or disclosure violation and offering them a return of their investment together with interest at the statutory rate. State law generally governs the interest rate payable in connection with a rescission offer and usually stipulates that a rescission offer in a state must remain open for 30, 60, or 90 days after the corporation provides the offering materials to investors who previously purchased the securities. If the investor elects to rescind, he/she will receive a return of their investment together with statutory interest, but will effectively forego any other remedies such as damages. Private rescission offers, just like a private placement in which capital is raised, must be exempt under Rule 504, Rule 505, Rule 506, or Section 4(2) (or perhaps some other exemption), or must themselves be registered, in which event they are referred to as registered rescission offers.

A private rescission offer will usually involve preparation of a complete private placement memorandum that focuses, in particular, on the violation that occurred and the rights of investors if they choose to rescind or if they elect to reconfirm their investment. The SEC and state regulators consider a private rescission offer to involve an investment decision, which is the reason that an exemption must be available for a private rescission offer. This is also the reason why a private rescission offering memorandum will usually provide information about the corporation that has been updated to reflect all material changes in the business that occurred since the prior investment was made.

- **Registered rescission offer**—If a corporation has undertaken a series of private placements over several years, and information was omitted or blue sky compliance was not undertaken in each offering, the corporation might have rescission liability that extends over several placements. In this event, an exemption might not be available to the corporation to make a rescission offer to the investors and, consequently, the corporation may have no choice but to register the rescission offer with
the SEC and the states in which the rescission offer will be made. This involves filing a registration statement on the form the business is permitted to use in order to register the securities that will be offered to those investors that reconfirm their prior purchase of the corporation’s securities. Those that do not reconfirm are entitled to receive a return of their investment, together with statutory interest, as in the case of a private rescission offer. Registered rescission offers are expensive, time consuming, and will generate lengthy and detailed reviews at the state and federal level.

• Disclosure of rescission liability—The other alternative open to a corporation that discovers a prior disclosure or compliance violation is to merely disclose to the current (rather than previous) investors the existence of the violation and the fact that the corporation may have a contingent liability to such investors. In a very real sense, this is the ultimate embodiment of the “disclosure cures all” maxim. That is, the corporation is disclosing to current investors a previous violation that may result in prior investors having some contingent rights of rescission or for damages if they elect to act on the violations. This disclosure is typically made in the Risk Factors, Management’s Discussion and Analysis of Financial Condition and Results of Operations, Business—Legal Proceedings, and Description of Securities sections of a registration statement. The financial statements will show the amount subject to rescission above the stockholders’ equity section of the balance sheet as “Common Stock Subject to Rescission” or under Commitments and Contingencies with a similar title.

**Why Would a Corporation Choose to Merely Disclose a Rescission Obligation Rather Than Curing the Contingency by Offering Rescission to the Investors?**

Two reasons behind the corporation’s disclosure could be:

1. The corporation lacks sufficient funds to pay the rescission obligation if all the investors entitled to rescind elect to do so. In these circumstances, the SEC has taken the position that the corporation is not able to consummate the rescission offer and, therefore, the corporation cannot make the offer equally to all investors. This is arguably a form of misrepresentation to the investors if the corporation cannot fund the rescission offer.

2. The time it would take to undertake and complete a rescission offer, particularly a registered rescission offer, can be a real obstacle to trying to conduct a rescission offer when the corporation is trying to complete another financing. The impact of this issue is multiplied by the fact that
a corporation cannot conduct any type of rescission offer while the corporation is in registration with, for example, an IPO. If the corporation elected to offer rescission to investors in a prior private offering after the corporation had already filed a registration statement for its public offering, the corporation would first have to withdraw the registration statement, then proceed with the rescission offer and, after closing that offer, re-file its registration statement. The time and expense of this process would be overwhelming, to say the least.

**Summary**

The form of disclosure documents used by a corporation in a financing transaction can range from a simple subscription agreement to a complex and lengthy purchase agreement or private placement memorandum. Documentation will, however, always be oriented to providing complete and meaningful disclosure to investors in a customary form, whether by exhibit and schedule or by integrated disclosure. The management team needs to carefully analyze, with the assistance of the corporation’s professionals, the optimum form of disclosure, the determination of whether to include projections, and how the corporation will offer and sell the securities in compliance with available federal and state exemptions. Once the form of disclosure and exemption have been determined, the management team must consider both the general (anti-fraud) and specific disclosure requirements that apply and ensure that the corporation has a disclosure and sales plan in place with which it can comply. This means considering specific exemptions, federal and state filing requirements, purchaser and dollar limitations, when the corporation intends to conduct its next financing, and the implications of applicable state blue sky laws and how they may affect the offering. The need for compliance with federal and state securities laws when making a private offering is amply demonstrated when one considers the problems that arise from violations that are detected after the placement has been concluded. Rather than playing Russian roulette with securities regulators, the corporation is far better off by avoiding compliance violations, providing comprehensive disclosure, and utilizing professionals who can assist the corporation in achieving and monitoring the compliance effort. Whether the corporation deals with a compliance or disclosure violation by means of additional disclosure or a rescission offer, the cost and time associated with the issues arising from a prior violation and any “cure” can be much more painful than the effort needed to ensure compliance today.

* * * * *
CASE STUDY: CLIENT MEETING PREPARATION

Clients are coming in for an advisory meeting on compliance issues prior to their meetings with several potential institutional investors. They need to understand what investors look for, what financial disclosure statements are required, and what mistakes to avoid. Here are some common questions and scenarios derived from the Chapter reading. How would you respond?

Situational Analysis

1. What are the five parts of a typical purchase agreement with a private equity group? Which of these parts is most important in conveying disclosure to a potential investor? How is this disclosure usually made?

Practitioner Response: The five parts of the typical purchase agreement are (1) terms of the investment, (2) representations and warranties, (3) covenants (negative and positive), (4) indemnities, and (5) miscellaneous provisions. The most important provisions that convey disclosure to potential investors are the representations and warranties and the exceptions to those representations and warranties. This disclosure is usually made in the form of schedules or exhibits to the purchase agreement.

2. What is a due diligence “out” and how does it work? If you are part of the corporation’s management team, how would you suggest the corporation approach such a clause when negotiating with an investor?

Practitioner Response: A due diligence “out” is a provision in the purchase agreement that permits an investor to terminate the agreement without liability to the small business if the investor finds the due diligence (or some portion thereof) to be unacceptable. When negotiating for the small business, you want to either (1) have the investor complete all of its due diligence before executing definitive agreements, in which case there would be no reason for a due diligence out, or (2) narrow the outstanding due diligence to two or three issues that could be specifically described in the definitive agreement as being the only areas, if found to be unsatisfactory in the purchaser’s reasonable judgment (rather than sole discretion), that would entitle the purchaser to terminate the purchase agreement.

3. What does it mean to “qualify” a representation or warranty? What are the most common forms of qualifying a representation or warranty?

Practitioner Response: Qualifying a representation or warranty means limiting its scope or meaning in a way that protects the small business. The most common form of qualifications are the use of terms such as “material,” “to the best knowledge” and similar terms that communicate a limitation in the representation or warranty. Dollar limitations are also used to establish materiality thresholds beneath which the representation and warranty does not apply.
4. If a corporation is not registering its securities, what forms of exemption might the corporation rely on? Can a corporation rely on more than one exemption? If a corporation has a federal exemption to offer and sell securities, must it also have a state exemption to offer and sell securities in a particular state?

**Practitioner Response:** The corporation that is not registering its securities may rely on exemptions from registration such as Regulation D (Rule 504, 505 and 506), Regulation A, or Section 4(2) of the Securities Act of 1933. A corporation can rely on more than one exemption if it meets the requirements of each of the exemptions. A corporation with a federal exemption must still have a state exemption available if it intends to sell securities in a state. The state filing and notice requirements are often different from federal provisions and are not uniform. Therefore, the small business management team has to be very careful not to rely on a federal exemption without investigating, and complying with, applicable state exemptions.

5. What are the two most common means of determining that an individual investor is accredited?

**Practitioner Response:** The two most common tests for determining whether an investor is accredited are (1) the net worth test ($1 million or more), and (2) income of over $200,000 in each of the last two years, and who reasonably expects to exceed that amount in the current year, or joint income of over $300,000 in the same periods.

6. What are the three ways that a corporation can deal with a prior compliance violation? Which method is the fastest and least expensive? Is this method more risky than the two others? Why or why not?

**Practitioner Response:** The three methods of addressing a prior compliance violation are: (1) conduct a private rescission offer, (2) conduct a registered rescission offer, and (3) disclose the potential rescission liability. The fastest and least expensive method is to simply disclose the existence of the potential rescission liability. This method is more risky than the other means of addressing a prior compliance violation since the disclosure will (1) put prior investors on notice that they may have a claim against the corporation, (2) put regulators on notice of the prior violations, and (3) may result in investment bankers determining not to proceed with an offering due to the higher risk inherent in such disclosure.
CHAPTER 6

"DEAL BREAKER" ISSUES

The issues that are “mission critical” to both parties in a financing transaction usually fall under one or more of the following categories:

- Valuation;
- Due diligence;
- Anti-dilution;
- Issues related to employment, stockholder and registration rights agreements;
- Corporate governance; and
- Other investment terms.

If the small business management team is to avoid a “flame out” of the transaction that is attributable to one of these issues, it needs to anticipate what may arise and develop well reasoned and persuasive responses that directly address the issue(s). This process is not merely one of responding to issues as they are raised, but knowing the strengths and weaknesses of the corporation’s position before the issue becomes a “deal killer.” This is particularly true in the context of due diligence, where the axiom “know thyself” is of utmost importance. The well-prepared management team will have established a proper foundation for investor due diligence by, among other things, reviewing and casting a critical eye on the corporation’s own due diligence. Having done so, the management team and its professionals should conduct “corporate cleanup” so that the corporate and financial records are as complete and accurate as the small business’s resources will allow before a due diligence package is ever furnished to a prospective investor.

Many investors will also use employment, stockholder and registration rights agreements to introduce new terms into a prospective investment that often present “deal killing” issues. Since many term sheets and letters of intent do not address, or address in only a limited fashion, the
issues covered in these agreements, the management team must anticipate that at least some of the topics in these agreements will be raised. Once again, professionals who can prepare the management team for what to expect, and officers who know what to anticipate, will be those that are the most valued members of the corporation’s financing team. These will also be the individuals who raise “deal killing” issues well before they reach the stage of having caused the termination of the financing.

**TYPICAL DISAGREEMENTS ON, AND NEGOTIATING STRATEGIES FOR, “MISSION CRITICAL” ISSUES**

**Valuation**

Once the investor has performed its valuation analysis, it is a safe assumption that the investor will run financial models that understate the corporation’s projections by 20% or more. Moreover, the investor may have adjusted the metrics that underlie the model to bring the metrics more in line with what the investor believes to be achievable. In either case, the valuation will reflect a lower enterprise value than management’s own models.

*Strategy I*

Ask the investor to share their valuation with the management team and attempt to ascertain what adjustments the investor made within its model of the projections. Many investors are willing to share their model with the management team. Once management has ascertained the differences in assumptions or metrics that have been incorporated in the model, it should marshal its arguments as to why the model is too conservative or demonstrate where the assumptions used are inconsistent with industry or corporation-specific metrics. Superior knowledge of the business and its metrics will pay dividends!

*Strategy II*

If the investor and the management team are both comfortable with the basic criteria used in the valuation model but the management team is still concerned about the valuation that is the end product, give serious consideration to negotiating for an equity claw-back that will allow management to increase its ownership percentage if the corporation meets designated financial objectives. Alternatively, if the corporation has already put into place a stock option plan, good advance planning would dictate that the board of directors would grant stock options to the management team before undertaking a financing transaction. If the investor treats the stock options as stock equiva-
lents, the management team might consider suggesting a vesting schedule for the options that is tied to the corporation meeting financial objectives. The end result will be similar to an equity claw-back but will not cause any adverse tax consequences that may result from an earn-out of stock.

**Strategy III**

In the context of a public offering, valuation discussions will be framed by the "comps," or valuations of other comparable public companies. Careful review of the comps used by the investment banking firm and an evaluation of other comps either in the small business's industry or a similar one may yield examples of comps that were not considered by the banker. Again, the management team may also seek to increase the effective valuation by having stock options in place or granting additional options at or near the offering price. *This enables the insiders to argue that the higher priced options, in effect, are not dilutive to the public.* (Although not dilutive from a price perspective, keep in mind that the banker will argue that the options are dilutive to earnings per share when considered as an equity equivalent.) While not ideal, an option position may allow the insiders to "claw back" some of their hard-earned ownership. Performance escrows that terminate on the corporation achieving financial benchmarks or at the end of a seven-year period can be functional equivalents to additional option grants, but without the attendant financial and tax consequences for the corporation or the insiders, respectively.

**Due Diligence**

The due diligence performed by investors and investment bankers is clearly corporation-specific, but can be summarized under the following broad categories:

- **Operational**
  - Business model: manufacturing, service, distribution or other;
  - Products or services provided;
  - Growth drivers and strategy;
  - Industry or market studies and surveys;
  - Sales and marketing channels and methods;
  - Suppliers and customers;
  - Intellectual property, whether owned or licensed, that may impact the business model;
  - Security;
  - Facilities; and
  - Insurance.
The CPA’s Guide to Small Business Financing

• Financial
  — Tax filings, disputes and policies;
  — Liquidity sources, current and projected, and prior financings;
  — Borrowings, collateral, and security preferences;
  — Information technology and systems;
  — Allocation of intangible assets;
  — Contingent and other known liabilities, including environmental issues; and
  — Capital equipment and expenditures.

• Legal
  — Charter instruments;
  — Actions or consents of the board and stockholders, and agreements of all varieties;
  — Pending or threatened litigation;
  — Transactions such as acquisitions, dispositions, mergers, asset purchases;
  — Indemnification, hold harmless, and guarantees; and
  — Classes and attributes of capital stock.

• Personnel
  — Board and committee composition, as well as qualifications;
  — Officers and their qualifications;
  — Background investigations;
  — Compensation paid and payable under plans;
  — Ownership interest and other incentives for performance;
  — Employee relations and issues; and
  — Related-party transactions.

• E-Business
  — Web site;
  — Hyperlinks;
  — E-security/intruder protection;
  — E-distribution or e-sales; and
  — E-employee recruiting.

• Outside Stakeholders
  — Stockholdings and ownership of warrants, rights or options;
  — Relationships with customers, suppliers, professionals, and stockholders;
  — Capital structure;
  — Exit strategies or undertakings;
— Investor relations practices and press releases; and
— Expansion possibilities through consolidation.

Assuming that the corporation has elected to prepare a complete due diligence package for delivery to an investor with which it has entered into a term sheet, the overall strategy should be to anticipate problem areas and address them before the due diligence is delivered. The following are some suggested preparatory steps that should be considered in this regard:

**Step I**

Adopting the investment banking theory that “it’s the jockey, not the horse”, make an unbiased assessment of the management team and its weaknesses. Are there holes in the organizational chart? If so, investors will identify those holes and that information may be used to justify a reduction in valuation or change in terms. A well-prepared management team will have identified the holes in the organization chart and may have secured “soft” commitments from prospective hires to join the corporation on the closing of funding. This approach accomplishes two objectives: it tells the investor that management knows where it is weak, and shows both a willingness and commitment to address that weakness prior to the investor’s raising the issue. In some instances, prospective employees may also consent to the corporation including a “no name” biography in the business plan that summarizes the experience and qualifications of the prospective employee without identifying him or her. This is clearly the best alternative for the small business, as it can then describe the quality of the pending hire in the business plan that is submitted to prospective investors.

**Step II**

The chief financial officer and/or controller should review the management letter from the audit firm or should ask an outside accounting firm to review the corporation’s accounting policies and procedures. This review should be undertaken to identify weaknesses in advance of due diligence by an investor. If the corporation has audited financial statements and has received one or more management letters, the management team should give consideration to implementing changes to policies and procedures or, at a minimum, committing to purchase or lease software or hardware resources that will be needed to do so.

Again, this commitment can be made “subject to funding,” if the cash is not available to do so before closing.

**Step III**

“Corporate cleanup” is a common term used by attorneys to describe what in medical terms would be characterized as a complete physical exam. Good corporate cleanup involves a comprehensive review of legal due dili-
gence by the corporate counsel with a view toward identifying and correcting deficiencies. For example, most private companies do not make it a habit to document meetings of the board or stockholders, even when significant issues are discussed. This can be corrected by reconstructing minutes of meetings from notes or, if no notes were taken, by preparing consents in lieu of meetings that authorize the action that was taken. Counsel and management should review the corporation’s files to ensure that, among other things:

• Contracts in the corporation’s files are current, signed and in effect;
• Employee handbooks and policies are in place and address current issues such as discrimination, sexual harassment and drug or alcohol abuse;
• The corporation’s governing (charter) documents are current and correct;
• Current industry information and available market information or studies have been downloaded off the Internet or otherwise sourced to support the information in the business plan;
• Marketing materials are up to date and reflect only currently offered products or services;
• The corporation’s Web site is scrubbed of irrelevant or inaccurate information and brought current;
• Intellectual property held by individuals has been properly assigned to the corporation, filings have been made, and licenses are current (both as to payment of license fees or royalties as well as performance);
• Any disputes with suppliers or customers are addressed and resolved to the extent possible;
• Credit and other financing agreements have supporting documentation and the corporation’s files include subscription agreements, copies of private placement memoranda, and federal and state notices and filings, including claims of exemptions;
• All licenses and authorizations from regulatory agencies necessary to conduct the corporation’s business are current and all fees have been paid;
• All leases and insurance policies are in effect and all rents and premiums are paid current;
• Any owned real estate is held in title by the corporation, all taxes are current, environmental surveys have been obtained and any abatement work has been completed by licensed contractors with a certificate of completion;
• Officers, directors and principal stockholders have each completed an officer’s, director’s and principal stockholder’s questionnaire;
• Employment and indemnification agreements are signed and current;
• Option grant agreements have been issued and all stockholder and board approvals have been obtained for option and other benefit plans;
• Documentation of related-party transactions is in place and approval of disinterested members of the board of directors has been obtained;
• Audit and compensation committees have been established and their memberships comply with applicable exchange listing requirements (or will do so prior to completion of IPO); and
• The corporation’s files contain copies of all press releases, other publicly disseminated information, and reports to the board of directors and stockholders.

Once counsel and the management team have completed the corporate cleanup, a complete set of due diligence files should be made for the corporation, its counsel, and the investor and its counsel. If prepared on a timely basis, the due diligence files should be ready for distribution to the investor and its counsel once the term sheet is executed.

**Practice Tip.** Part of legal due diligence encompasses a discussion of anti-takeover measures that the corporation should consider adopting prior to seeking outside funding. The management team should seek to update anti-takeover measures before each funding round or, at a minimum, confirm with counsel that the anti-takeover measures in place are current and still of some use. In general, most corporations have put the following measures in place prior to a public funding and good planning dictates that some or all of these measures should be submitted for stockholder approval prior to significant private or public financing if not previously in place. Anti-takeover measures may include:

• Authorization of "blank series" preferred stock that can be issued on terms later determined by the board of directors;

• Provisions in the articles and/or bylaws that:
  — Permit the board to be divided into three equal classes, with each class being elected to a different three-year term (referred to as a “staggered” or “classified” board);
  — Require super-majority votes of the stockholders to remove a director or to effect a change in the size of the board;
  — Call for significant advance notice and carefully prescribed procedures that apply if a candidate is to stand for election to the board and is not nominated by the board of directors;
  — Limit the ability of persons other than the board or chief executive officer to call meetings of the board;
  — Require a vote of the stockholders to remove a director for cause; and

• Once the corporation is public, the adoption of a stockholder rights plan that grants to each common stockholder rights to purchase shares of common stock at a fraction of the market price once the corporation receives a tender offer or proposal for a non-negotiated change of control.
Anti-Dilution

Anti-dilution is often cited as a "deal breaker" by venture and private equity groups that are generally unwilling to negotiate on this issue. Depending on whether the corporation has other potential investors and the relative negotiating positions of the parties, it is possible to negotiate for certain limitations on price anti-dilution. While the management team may not be successful in this effort, the dramatic effect of price anti-dilution clauses, in particular, on the stockholders' mandate that the management team at least attempt to negotiate this issue. Again, there are two types of anti-dilution clauses that are used in purchase agreements: price anti-dilution and anti-dilution clauses that take effect on stock splits, dividends, mergers, or other reorganizations. The latter type of anti-dilution clauses are customary and, while the language must be carefully reviewed to avoid giving unintended protection, the management team is best to focus its attention on any price-related anti-dilution clauses.

Price anti-dilution clauses are triggered if the corporation sells common stock, convertible preferred stock, warrants or similar instruments to purchasers at a price less than that paid by the investor. In this event, the number of shares of common stock that the investor is entitled to receive on conversion of its preferred stock or on exercise of warrants is automatically increased by the number of shares of common stock necessary to reduce the effective price per share paid by the investor to a price equal to that paid by the most recent purchasers. Price anti-dilution clauses can operate to the significant disadvantage of the corporation's stockholders, including management, who acquired their shares of common stock prior to the investment by the venture or private equity group.

Consider the following example:

<table>
<thead>
<tr>
<th>Shares</th>
<th>Number of Shares</th>
<th>Price of Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock held by founders</td>
<td>5,000,000</td>
<td>$.50</td>
</tr>
<tr>
<td>Common Stock issued to non-founder management</td>
<td>1,000,000</td>
<td>$1.25</td>
</tr>
<tr>
<td>Common Stock issued to angel investors</td>
<td>750,000</td>
<td>$1.75</td>
</tr>
<tr>
<td>Preferred Stock issued to private equity group convertible into Common Stock on 1:1 basis</td>
<td>2,500,000</td>
<td>$3.50</td>
</tr>
<tr>
<td>Common Stock issued to new purchasers</td>
<td>500,000</td>
<td>$2.50</td>
</tr>
<tr>
<td>Common stock to be issued to private equity group for anti-dilution</td>
<td>1,000,000</td>
<td>$0.00</td>
</tr>
</tbody>
</table>
In this example, assume that the corporation required bridge financing of $1.25 million that will be provided by the new purchasers buying the 500,000 shares at $2.50 per share. If the corporation closes on the bridge financing without obtaining a waiver of the price anti-dilution clause, the conversion price of the preferred stock would re-set to $2.50 per share, entitling the private equity group to receive 3.5 million shares of common stock, rather than 2.5 million. This would increase the total outstanding shares on conversion of the preferred stock to 10,750,000 shares, with the result that the founders’ ownership would have been reduced to 46.5% instead of remaining at over 50%. Therefore, the founders would not only have lost voting control of the corporation, but the effective price of the bridge financing would have far exceeded what management may have planned for.

**Practice Tip.** There are a number of variations in price anti-dilution clauses that can be negotiated that are less injurious to existing shareholders’ interests than the example outlined above. Consider the following strategies when faced with an investor that is insisting on this type of protection.

**Strategy I**

Rather than granting the investor price anti-dilution that commences immediately or that is triggered on any sale below the investor’s price, management should seek to limit price anti-dilution to sales commencing after expiration of one year. The argument that management can advance is that this type of modification will provide protection against the long-term dilution about which the investor is justifiably concerned, without adversely impacting the corporation’s ability to raise additional capital. This is particularly true if the corporation finds itself in the position of requiring additional capital in the short term and is able to secure funding at a price reasonably close to that paid by the private equity investor. Management should also note that the existence of the price anti-dilution clause could discourage another prospective investor from investing in the corporation if the prospective investor focuses on what effect its investment will have on the prior investor’s position. It is not uncommon for prospective investors to ask that prior investors waive a price anti-dilution clause, particularly if the prior investor has no further funding commitments and the corporation is in dire need of the additional capital. Hence, providing some reasonable parameters as to the scope and application of the price anti-dilution clause may be critical to the success of the corporation’s future funding efforts.

**Strategy II**

A different variation on a straight price anti-dilution clause is for the corporation to provide protection against dilution in ownership percentage,
rather than price, if sales are made at a level below that paid by the investor. This is technically not price anti-dilution, but this type of protection can use sales of equity at a price below that paid by a prior investor as a trigger for the issuance of “anti-dilution” shares. For example, if this type of protection had been extended to the private equity group in the hypothetical given above, the sale of the 500,000 shares to the new purchasers would have increased the total outstanding shares to 9.75 million. Based on the private equity group’s ownership of 27.03% of the total outstanding shares prior to the sale of the 500,000 shares, the “ownership percentage” anti-dilution clause would entitle the investor to receive an additional 135,000 shares if the newly issued shares are sold for a price less than that paid by the private equity group. By reducing the number of “anti-dilution” shares issued from the 1 million shares described in the prior example to 135,000 shares, it is obvious that “ownership percentage maintenance” anti-dilution is much more favorable to the other stockholders and much less favorable to the investor holding anti-dilution rights. The use of this strategy enables the management team to argue that the investor has not had its ownership diluted, which ostensibly is the prior investor’s concern, while avoiding the severe consequences to all of the other stockholders who would be penalized by the effects of a full price anti-dilution clause.

Strategy III

Although the “just say no” strategy is likely a non-starter with sophisticated institutional investors, management of the small business may consider arguing that price anti-dilution is unnecessary if the investor has performed its valuation work and is comfortable with the valuation of the equity at the time it is purchased. In other words, if the business model can be executed only with additional capital, and that capital is to be invested at a lower valuation than prior sales, the decrease in valuation may be consistent with a changing risk profile for the business. This change does not necessarily mean that management did not execute on its plan, but could reflect changing industry or market conditions. Of course, the difficulty with this argument is that the investor will attribute a failure to execute the business plan to management, regardless of whether other factors influenced results of operations, and will want management to “feel the pain” of the lower valuation. Management might consider proposing a proportional anti-dilution clause that provides limited price protection that increases as the price decreases. In other words, if a subsequent sale of equity is made within 20% of the investor’s price, there would be no protection; if the subsequent sale is made between 20% and 30% of the investor’s price, the investor would receive 50% anti-dilution coverage; and if the subsequent sale was made at a price more than 30% below the investor’s price, there would be full anti-dilution coverage.
Employment, Stockholder, and Registration Rights Agreements

These agreements are often the source of contentious issues that can derail any financing transaction. Appendix I, “Executive Employment Agreement,” and Appendix J, “Stockholders Agreement,” contain a sample employment agreement and a sample stockholder agreement in forms that are customary in venture and private equity transactions. Appendix K, “Registration Rights Agreement,” is a sample registration rights agreement. These Appendices contain the provisions that are highlighted below. The reader should keep in mind that while these samples are typical “real life” agreements, variations in the nature of the transaction or in the negotiated terms may cause the form and content to vary somewhat from that presented in the Appendices.

The following are some of the more common issues that may arise when dealing with these agreements:

• **Employment I:** Investors will generally want the key members of the management team to have employment agreements in place. This involves designating key members, sometimes a touchy subject if new officers will be hired following the closing of the financing. Moreover, differences in the terms of employment agreements offered to executive officers may likewise trigger disagreements with the investor or perhaps among members of the management team. The duration of employment agreements can similarly raise issues that relate to differences among members of the management team or a difference in the views of management and the investor.

• **Employment II:** Termination clauses and severance provisions also cause disputes both within and outside of the management team. While it is customary to provide for termination for cause, provisions that permit termination without cause may cause some officers to question the longevity of their employment with the corporation. The existence of “without cause” termination clauses will usually, at a minimum, result in the officers seeking more lengthy severance payment terms as protection against termination without adequate cause.

• **Employment III:** The employment agreement typically contains the non-compete, confidentiality and non-solicitation obligations of the officer that prevent the officer from engaging in competition with the corporation, using corporate information, or soliciting corporate employees for subsequent employment. These provisions may have a direct impact on the ability of the officer to make a living and, therefore, are often the subject of considerable negotiation.

• **Employment IV:** Appendix I, “Executive Employment Agreement,” also contains, among other things:
— A provision in paragraph 3 concerning relocation obligations of the executive;
— An "evergreen" provision (see paragraph 4) that automatically extends the term of the employment agreement for additional one-year periods as the executive completes each year of service, a very desirable clause from the officer's individual perspective;
— Provisions in paragraph 7 that obligate the corporation to reimburse the executive for his legal fees unless the executive is the losing party in an action adverse to the corporation; and
— A carefully drawn definition of what constitutes "cause" for termination (see paragraph 13(b)).

• Stockholder I: Once the issue of termination of employment is raised, the next most likely issue that will need to be addressed is the disposition of stock and/or options held by members of the management team who are no longer actively employed by the corporation. This issue is usually addressed in the stockholder agreement, and typically involves the grant of a right of first refusal to existing stockholders, or perhaps to existing stockholders and the new investor, under which they have the right to purchase the ex-officer's shares. The purchase price sometimes is based upon a formula, but may permit either party to set a value that, if not agreed to by the other party, entitles the selling shareholder to retain either an investment banking firm or accounting firm to establish a valuation for the shares. If that valuation is unacceptable to the purchasing party, the stockholder agreement usually provides for the purchasing party to obtain a valuation. The two valuation firms then select a third firm whose valuation will control for purposes of establishing the sale price.

• Stockholder II: The stockholder agreement will also contain:
  • Restrictions that prohibit the transfer of securities to persons not a party to the stockholder agreement and descriptions of any permitted transfers;
  • Provisions that permit each stockholder, including the new investor, to participate pro rata in the purchase of shares that a selling stockholder, departing officer, or the estate of a deceased stockholder may want to sell;
  • The "tag-along" and "drag-along" rights that permit, or obligate, a selling shareholder or the corporation to participate in a sale of shares to a third party;
  • Preemptive rights that permit existing investors to purchase, on a pro rata basis based on their percentage ownership of the corporation, any additional securities issued (with certain exceptions);
  • Provisions concerning the obligation of the stockholders to vote for certain board members, or their designees;
• Grants of proxies to the board of directors that permit the board to vote the shares of any permitted transferee of a stockholder that is a party to the stockholder agreement; and

• Sunset provisions that specify when the various restrictions imposed by the stockholder agreement, or the entire agreement, are no longer binding.

**Practice Tip.** Assuming the investor has negotiated for tag-along rights in any sale of shares by members of the management team or founders, the management team should be negotiating for drag-along rights so that the investor could not stand in the way of a proposed sale. Most investors will condition exercise of drag-along rights by the corporation on the corporation meeting some minimum value in the sale transaction (e.g., at least a value to the investor that is equal to the liquidation value). This is not unreasonable given the fact that the investor's capital contributed to an increase in enterprise value that should be reflected in the sale price. The management team may also consider negotiating for a clause in the stockholder agreement that would permit a sale (and exercise of the drag-along rights) if a minimum of 66% or 75% of the holders of the preferred stock voted in favor of the sale. If the preferred stock is being sold to multiple investors, this clause may facilitate a sale and exercise of the drag-along rights when a super-majority of the investors, but not all, can be convinced of the benefits of the sale. The burden of securing a unanimous vote may prove too much if one or two preferred stock investors are reluctant to agree to a sale for reasons that may or may not be related to the sale.

• **Registration Rights Agreement I:** The registration rights agreement is designed to facilitate the investor registering and selling its shares into the public market once the corporation has completed its IPO. The typical agreement comes into effect once the corporation completes the IPO and extends for a period through the earlier of sale of all of the registered securities, until the remaining securities can be sold under Rule 144, or until the passage of two years.

• **Registration Rights Agreement II:** Note the following provisions of Appendix K, "Registration Rights Agreement:"
  — The investor is granted under paragraph 2 both demand and “piggy-back” registration rights, including two open demand rights, three demand rights using an S-3 registration statement, and unlimited piggyback rights, all at the corporation's expense. This can get expensive and, therefore, the management team must be careful about how far it is willing to go in granting registration rights!
  — The cash penalty provision that is contained in paragraph 2.2(a). This clause obligates the corporation to pay a cash penalty to the holders of the registration rights if the corporation is unable to obtain a timely declaration of effectiveness from the SEC once it files a registration statement.
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**Practice Tip.** This type of clause may be very costly if unexpected events intervene in the registration process and, when negotiating the registration rights agreement, the management team should seek plenty of time to obtain a grant of effectiveness.

- The language in paragraph 2.3 that allows the corporation to give the holder notice of suspension, under which the holder agrees to suspend sales of securities for up to 90 days in any 12-month period. This clause can be used to suspend sales when, for example, a corporation has an acquisition pending and requires time to update the prospectus to include the financial statements of the acquired concern.

- The corporation's undertaking to timely file all of its reports under the 1934 Act so as to enable the holders to make sales under Rule 144.

- The "most favored nation" clause that is carefully hidden in paragraph 3(k) just above the signature page. This language provides a great benefit to the investor that is somewhat akin to price anti-dilution, in that the investor is given the right to benefit from more favorable registration rights granted to other investors that participate in the financing.

  **Practice Tip.** The management team should exercise caution if this language applies to subsequent private financings as later investors may negotiate for more favorable rights than those granted in prior rounds of financing.

  **Practice Tip.** The following are a few additional strategies that management may wish to consider when negotiating registration rights agreements.

- Demand registration rights exercisable within one year of the IPO are typically expensive since the corporation pays all costs associated with the registration of the investor's securities and the corporation cannot yet use a Form S-3 to register the securities. Once the one-year period has passed, many investors will seek unlimited registration of their securities. If possible, the management team should negotiate for a strict limitation on exercise of registration rights during the first year and a limit on the number of subsequent demand registrations. Since piggyback rights are exercisable if the corporation is registering securities for its own account, the expense of registering the investor's securities should be negligible if they are "piggybacked" onto another registration statement. Again, the management team might consider limiting the number of demand or piggyback registrations once the investor has received a return of invested capital or, alternatively, might negotiate for some cost participation by the investor in later registrations.

- Generally speaking, an investor will be entitled to a return of invested capital first before the common stockholders receive any portion of the proceeds of the sale of the business. This is not normally the subject of
Chapter 6: “Deal Breaker” Issues

negotiation, at least from the investor’s point of view. The management team should, however, focus on registration or sale rights that the investor seeks in conjunction with the IPO. The management team should expect that the investment bankers will want the investor to enter into a lock-up agreement for some minimum period after completion of the IPO. Anticipating this, the management team might want to negotiate for a clause to be placed in the stockholder agreement that commits the investor to executing a lock-up agreement on terms identical to those imposed on the officers and directors. The management team should be leery of committing to a registration of the investor’s securities in the IPO due to regulatory concerns as well as the impact such registration could have on the marketability of the corporation’s securities.

Corporate Governance and Other Investment Terms

The stockholder agreement and the purchase agreement generally contain restrictions on, or provisions concerning, corporate governance. As noted above, the typical stockholder agreement grants the investor the right to appoint one or more members to the board of directors. Venture and private equity firms will many times seek to negotiate for a rachet clause that will increase their representation on the board of directors if the corporation fails to meet previously agreed-upon performance objectives. Angel investors and mezzanine lenders may negotiate for the right to have an observer attend board meetings, but rarely are given contractual rights to appoint members of the board.

Venture and private equity investors, as well as mezzanine investors or lenders, usually have provisions built into their purchase or loan agreements that obligate the corporation to obtain approval of 51%, to as much as 75%, of the holders of the preferred stock or mezzanine financing before:

- Engaging in transactions that would affect the priority of the security held by the investor;
- Amending charter documents in a way that would adversely affect the rights of the investor;
- Issuing options or warrants to employees in excess of designated limits;
- Engaging in related-party transactions without approval of disinterested directors;
- Being party to a change of control transaction; or
- Paying dividends or distributions to any securityholders.

Banks often place some of these provisions in their loan agreements as well, although banks are usually unconcerned with dilution caused by issuance of options. These provisions (examples of which appear in Appendix A, “Sample Term Sheet for Preferred Stock Purchase by Venture
or Private Equity Investor,” in clause IV and in Appendix C, “Senior Subordinated Debt (Mezzanine) Term Sheet,” on page 188) are referred to as negative or restrictive covenants. So long as these covenants remain effective, they may significantly restrict, or even eliminate, the ability of the board of directors or the stockholders to engage in the described activities or transactions.

**Practice Tip.** Given the nature of the restrictions imposed by negative covenants, the management team should concentrate its efforts in the area of corporate governance on reducing, to the extent possible, the percentage vote required to approve the activities or transactions in question. Alternatively, management might consider negotiating for a time limit on the effect of some negative covenants that would be tied to the retirement of a portion of the loan or to the redemption or conversion of a portion of the preferred stock.

The following are some miscellaneous issues that relate to corporate governance and other investment terms:

- **Voting rights** given to the holder of preferred stock are rarely negotiable and usually allow the investor to vote on an “as-converted” basis. In addition, the rank of the preferred stock is fixed and will not be negotiable from the investor’s point of view. The liquidation preference is also sacrosanct and difficult to argue against since the investor will take the position that the liquidation preference is the investor’s only “security” if the corporation is not successful. Rather than attempting to negotiate these generally non-negotiable issues, the management team might seek to “turn the tables” on the investor by asking for the opportunity to co-invest alongside the investor on the same terms. If the management team does not possess the financial resources to purchase preferred stock using cash, the management team might seek to invest through issuance of preferred stock for services. While there are obvious tax consequences to this, restrictions on the transferability of the preferred stock may affect the valuation of the preferred stock for purposes of calculating any tax due.

- Most investors will insist that the corporation have audited financial statements completed prior to the closing, although occasionally an early stage corporation with limited operations may be able to negotiate for the delivery of audited statements only on a post-closing basis. Because many banks require the small business to provide audited financial statements as a condition to renewal of revolving credit agreements, management should plan ahead and arrange for an audit before this becomes an issue.

- The early or operating stage business that needs to conserve cash should consider a PIK that is payable in preferred stock or additional debt instruments such as debentures. If the preferred stock is convertible and
dilution is a concern, suggest that the corporation be given the option to pay interest in cash or a promissory note that becomes convertible if not retired by a date certain. In this fashion, if the corporation is successful in generating excess cash, it can be used to reduce dilution that would otherwise be experienced by the stockholders and management team.

- Since most investors will negotiate to have the corporation pay the investor's expenses and the majority of these expenses are legal fees incurred in preparation of the investment documents, it is often a good idea to negotiate for a cap on the legal fees above which the investor will have to pay the expenses of its counsel. Some investors will permit the corporation's counsel to prepare the first draft of the investment documents, although other investors will insist that their form of documents be used and that their counsel prepare the first drafts.

**Summary**

As the corporation heads toward closing of a financing, the "deal breaking" issues that we have reviewed will often "rear their ugly heads." Critical issues such as valuation, due diligence, and anti-dilution must be understood and evaluated and, to the extent possible, the impact of these issues on the corporation should be limited where practicable. Investors and mezzanine lenders may use employment, stockholder, and registration rights agreements to import new terms into a transaction or may use these agreements to expand their rights in ways that are not addressed in the term sheet or letter of intent. Again, a careful reading of these agreements, and negotiation of some of the more onerous terms, will be necessary. The management team should be aware that investment and loan documents contain negative covenants and other provisions that will operate to the corporation's disadvantage, and be prepared to advance proposals, or suggest alternative formulations, that will let the investor or lender know that the management team has done its homework.

* * * *

**Case Study: Client Meeting Preparation**

An investor has approached clients with a financing opportunity. It could be finalized quickly and would have broad implications for their corporation. They have requested an advisory meeting to discuss the potential deal breakers, and also to understand their rights and obligations under the proposed agreement, both now and moving forward. Here are some common questions and scenarios derived from the Chapter reading. How would you respond?
Situational Analysis

1. What steps should the management team take to prepare for a discussion of valuation with prospective investors?

**Practitioner Response:** The management team should first seek to obtain the valuation model that has been prepared by a prospective investor. This will allow the management team to evaluate what changes in metrics or assumptions have been made and that have affected the valuation. The management team should also be familiar with valuations of public and private companies within the small business's industry and those metrics that the market or investors are most focused upon when valuing the corporation. Researching and understanding valuation models within the small business's industry is one of the most important steps management can take in educating and preparing itself for valuation discussions.

2. What are the most important subjects that management should consider when conducting a “self analysis” of the corporation?

**Practitioner Response:** The most important subjects to be considering in analyzing the corporation are the operational and other aspects of due diligence. The broad categories of due diligence listed in the Chapter provide a framework for the analysis that should be conducted by management before an investor has even been contacted. In summary, management should consider and evaluate operational, financial, legal, personnel, e-business, and outside stakeholders when performing the “self-analysis.”

3. How does price anti-dilution affect the interest of stockholders, other than an investor with this protection?

**Practitioner Response:** Price anti-dilution clauses can greatly dilute the interest of stockholders who are not beneficiaries of the anti-dilution clause. As the conversion or exercise price is adjusted downward, the investor who has price anti-dilution protection will receive more shares for the same aggregate investment once the shares are converted or the warrants exercised.

4. What is a “most favored nation” clause in a registration rights agreement? Why should management be concerned about such a clause?

**Practitioner Response:** A “most favored nation” clause in a registration rights agreement provides that if the corporation grants registration rights in a financing (or sometimes with respect to subsequent financings) that are more favorable than those granted to the investor in question, the investor will automatically be granted (or its registration rights will be deemed to have been automatically upgraded) registration rights equal to the most favorable rights granted to another investor. Management should be concerned about this clause since investors with considerably less invested, or with significantly less bargaining power, may be automatically vested with much broader (and more expensive) registration rights that are secured by larger investors that participate in a later round of financing.
5. In negotiating your own employment agreement with a financial investor, what protections should you seek in your agreement? What issues will the financial investor raise? How would you respond to these issues?

**Practitioner Response:** You should be focused on negotiating termination and severance provisions, as these are your protection from being jobless and having no means of supporting yourself and your dependents. The definition of “termination for cause” and the circumstances under which you will receive severance are critical. This is not to say that the duration of the contract, the description of your responsibilities, to whom you report, the compensation you will receive and your benefits are unimportant, but these provisions usually receive attention more readily. The financial investor will want to discuss these provisions, termination and severance, non-compete and non-solicitation, and provisions for the assignment of intellectual property developed by you during your employment. Since no one will be able to secure all the provisions that he/she would like, an effective approach might be to rank the issues in a hierarchy that allows you to focus on the really important issues without being distracted by some of the less important ones.

6. Are voting rights and liquidation preferences negotiable with a financial investor? Why or why not?

**Practitioner Response:** Voting rights and liquidation preferences are rarely negotiable with a financial investor. These rights are jealously guarded by the financial investor because (1) the voting rights provide the investor with the means to veto transactions outside the ordinary course of business, and (2) the liquidation preference provides a measure of protection to the financial investor if the corporation is unsuccessful. The liquidation preference also places the investor ahead of common stockholders such as management in the event of a bankruptcy or reorganization, which is not only beneficial from a financial point of view, but may entitle the investor to a greater voice (as a secured creditor) in the decision making process that follows. For these reasons, management should not waste much time or effort in negotiating these points.

7. What investor expenses should the corporation expect to pay when dealing with an institutional investor?

**Practitioner Response:** The corporation should be expecting to pay the investor's legal fees (up to some predetermined amount), collateral audit expenses, and perhaps out-of-pocket expenses up to a predetermined amount. In unusual situations, the corporation might be asked to pay the costs of a consultant or expert required to evaluate a technology, a review of intellectual property rights by intellectual property counsel, or other third-party expenses incurred as a result of the financing.
CHAPTER 7
DOCUMENTING THE FINANCING THROUGH CLOSING

Having surmounted many obstacles to reach this point, the small business corporation is now poised to conclude a financing transaction. While due diligence is likely to be ongoing as the purchase agreement is drafted and negotiated, the management team will likely be focusing its energies on understanding the import of various portions of the purchase agreement and working with the corporation’s professionals to limit the impact of these provisions on the corporation. The purchase agreement can be generally divided into five parts that will each be reviewed in more detail in the following discussion:

• A description of the amount and terms of the investment or credit facility;
• Historical information that is covered by representations and warranties;
• Forward-looking information addressed by covenants;
• Exceptions described in schedules and exhibits; and
• Descriptions of defaults, remedies, and indemnities.

Assuming the corporation has performed its own comprehensive due diligence, or if disclosure issues are surfaced in the course of due diligence by the investor or investment banker, the management team must now prepare disclosure schedules or exhibits that fully inform the investor of the nature of the exception to the representation, warranty, or covenant. In the context of a public offering, the development of this type of information may require disclosure in the prospectus if the issue is material or meets the materiality threshold contained in the applicable rule or regulation.

Disclosure on the face of the financial statements or footnote disclosure may also be required. No matter what form the disclosure takes, it is important to note that how the disclosure is worded may be more important than the fact of disclosure itself. This is particularly true in purchase
agreements when the management team is faced with disclosure of facts that might have a negative impact on the investor’s perception of the funding transaction or trigger a re-negotiation of the terms of the financing.

The other topic covered in this discussion deals with defaults and the remedies available in the purchase agreement to the financing provider. A number of these provisions may impose individual obligations on the management team or may empower the investor to effect a change in management if designated objectives are not met. In addition, the corporation may become obligated to indemnify and hold harmless the investor, raising issues of when indemnity obligations arise and to what extent the corporation may have exposure to third parties or stockholders. As the financial consequences of these provisions may be serious, the management team must fully comprehend the extent to which the corporation has assumed financial responsibility when agreeing to these types of provisions.

**Equity and Debt Purchase Agreements**

As referred to previously, Appendix H, “Series A Preferred Stock Purchase Agreement,” to these materials is a prototypical purchase agreement used by venture firms and private equity groups. Appendix L, “Subordinated Loan Agreement,” is a prototypical debt financing agreement in the form of a $30 million mezzanine financing. If the reader compares these two Appendices, it will be clear that the two agreements share a number of common attributes, as most financing documents do. The following highlights some of the similarities and differences in these documents:

- After addressing the definitions in Appendix L, both agreements then set forth the terms of the financing that will be undertaken;
- Article III and Section 3 of both agreements contain the representations and warranties of the company;
- Appendix L next sets forth the affirmative and negative covenants, most of which (excepting the financial ratios) are addressed in the equity financing in Appendix J, “Stockholders Agreement;”
- Appendix L then addresses subordination of the mezzanine financing; the description of the rank of the securities being issued pursuant to Appendix H is within the Restated Certificate of Incorporation and the Stockholders Agreement;
- Appendix H has representations and warranties of the purchasers of equity for purposes of securities compliance, while Appendix L has an operations section and description of the Agent’s ability to act on behalf of all the lenders;
- Article X of Appendix L and Sections 2 and 5 of Appendix H address closing conditions and mechanics; and
• Each agreement concludes with miscellaneous issues that consider issues such as amendments, disputes, applicable law, expenses, and successors and assigns.

**Representations and Warranties**

Representations and warranties are historical statements of fact or promises that a certain condition exists. Most investors and lenders prepare representations and warranties without qualification; that is, the representations and warranties are made unconditionally. This is the reason that management and counsel will spend significant time seeking to qualify the representations and warranties with knowledge, materiality or dollar thresholds. This is especially important when default or indemnity clauses are triggered by a breach of a representation or warranty, since the qualifier may be what avoids a lawsuit between the parties. For example, if the corporation represents that it is not in default with respect to any material contracts, the existence of a default in a small contract not material to the business that comes to management’s attention only after the closing will not trigger a default or a right to indemnity for the investor or lender.

Representations and warranties are generally more comprehensive in equity financing documents than in debt financing documents. This is due to the fact that a lender usually has more bargaining power and is able to impose more covenants as a condition to the loan, rather than merely obtaining historical information through representations and warranties. To some extent, this reflects the fact that lenders are more oriented to what the corporation will do after the loan is made, while equity investors are more concerned with whether the historical facts are correct and can be relied upon when making the investment decision. This is also reflective of the fact that the risk profile sought by lenders is significantly different from that of an equity investor.

Examples of representations and warranties given in an equity financing appear in Section 3 of Appendix H. Again, since equity investors are particularly used to obtaining comprehensive representations and warranties, the focus of the management team should be on how to qualify the representations and warranties, rather than trying to eliminate them.

**Covenants**

Covenants relate to future events, rather than historical events. As illustrated in Appendix L, there are both affirmative and negative covenants in a loan agreement. The covenants in Appendix J are referred to generically, but include both affirmative and negative covenants. As is obvious from their labels, affirmative covenants speak to what the corporation agrees to
do in the future, while negative covenants tell what the corporation will not do. Negative covenants normally remain in effect until expiration of a specified time frame or until approval of a minimum percentage of the holders of equity or debt instruments. Negative covenants generally prohibit the consummation of mergers, acquisitions, or similar corporate transactions, distributions, dividends, issuance of debt or equity instruments, sale of assets, transactions with affiliates, or capital expenditures over permitted amounts.

Affirmative covenants typically remain in effect for the life of a debt financing, while affirmative covenants in equity documents normally remain in effect until equity holders have disposed of a specified percentage of their holdings or a liquidity event occurs such as a public offering or sale. Affirmative covenants include the obligation to deliver financial statements, have audits performed, future compliance with financial ratios, and maintenance of such items as insurance, licenses, supply or customer agreements, compliance with laws, and stockholdings.

*One of the more common issues that is addressed through covenants is the maintenance of control by management.* This issue is key to equity and debt financing sources alike, since the ownership interests held in the corporation by key members of management are the primary motivating factors for their involvement. Here are some of the ways in which this issue is dealt with through covenants:

- In early stage corporations receiving equity investments, most venture and private equity firms will achieve their goals through insisting on a *repurchase agreement between the corporation (or perhaps the investor) and the key members of management* that becomes effective if the employee is terminated. Most members of management will negotiate for something less than 100% of their shares being subject to the repurchase right and a stipulation that the repurchase right is only exercisable if the employee is terminated for cause. As could be expected, the investor may insist on some repurchase right if the employee terminates his/her employment without cause, as opposed to the corporation doing so. The other significant issue that is addressed in this covenant is *the valuation of the shares once they become subject to repurchase.* Many repurchase agreements contain valuation formulas based on multiples of EBITDA or earnings, while others base the repurchase price on the most recent price paid by outside investors or a valuation arrived at by use of one or more outside valuation firms.

- Another mechanism used to control, but not eliminate, sales of shares by management are the tag-along rights that most early stage investors will insist upon receiving. As previously described, the tag-along right provides that if a member of the management team arranges a private sale of more than a set percentage of the shares he or she owns, the investor(s) and perhaps other insiders who are party to a stockholder agreement will
have the right to "tag-along" on a pro rata basis in the sale transaction. An example of this type of clause appears in Section 2.2 of Appendix J.

- As set forth in Section 2.1(d) of Appendix J, both management and the other parties to the stockholder agreement are prohibited from making any transfers of their shares to competitors.

- In public companies that are receiving private equity or mezzanine financing (sometimes referred to as PIPEs: Private Investment in Public Entities) the covenants typically provide that management will maintain ownership of not less than some designated percentage of the corporation. For an example of this type of provision, see Section 4.19 of Appendix L. This covenant typically has some downside protection built in that allows management to sell a reasonable number of shares in 144 sales or upon exercise of options. It would be highly unusual to have a repurchase agreement in effect such as that described above in the context of a public company due to the existence of a public market. The transfer restrictions in these types of covenants generally exclude transfers made for estate planning purposes.

When the management team is negotiating the language of covenants with an investor or lender, the focus is usually on the means of, and time permitted for, covenant compliance. For example, if a corporation will commence audits of its financial statements only after a financing is received, the management team might want to extend the time period for delivery of the first set of audited financial statements somewhat in order to allow additional time to address issues that might arise in the audit. Covenants that relate to limitations on acquisitions, sales of assets, capital expenditures and distributions or dividends can be negotiated to include dollar threshold limitations below which the management team will have flexibility and discretion to undertake these types of transactions. (For examples using these types of materiality thresholds, see Sections 5.10, 5.13, and 5.16 of Appendix L.)

Covenants that require more generic qualification may require management to use language providing that the covenant will be complied with "except to the extent that the failure to comply would not have a Material Adverse Effect." (See Section 4.15 of Appendix L for an example of a covenant that uses this language.) Since the definition of material adverse effect is usually somewhat general itself, the corporation may benefit from a reluctance on the part of investors or lenders to litigate a dispute about what constitutes a material adverse effect unless the event of noncompliance is clearly material. Although it can be argued that this type of language can benefit a lender or investor by allowing a default to be declared in circumstances that do not permit an objective determination of a default, the prominence of lender liability and controlling stockholder legal actions will normally act as something of a restraint on what otherwise might be viewed as an abuse of discretion by a lender or investor.
A good example of this type of clause was a similar covenant in the merger agreement between Dynergy and Enron that permitted Dynergy to back out of the merger if Enron suffered a material adverse change. When the ratings agencies downgraded Enron’s debt to junk status, this accelerated a material portion of Enron’s outstanding debt, which Dynergy interpreted as a material adverse change, causing it to cancel the merger. Enron’s suit for damages as a result of the cancellation of the merger is pending and it will be up to a court or jury to determine whether the events that happened constituted a material adverse change.

The Bottom Line. The use within covenants of materiality qualifiers, dollar thresholds, and notice provisions before a default can be declared are powerful means of building in additional flexibility and time for the corporation. Otherwise, the corporation might be faced with the prospect of having to inform the lender or investor of an adverse event, or even receive a notice of default.

Rights of First Refusal and Preemptive Rights

Another clause that is critical for management to focus on when undertaking equity or mezzanine financing is any type of right of first refusal or preemptive right. These clauses can operate to the significant disadvantage of the management team and/or founders, as described below:

• If an investor is granted a right of first refusal to purchase all of the securities offered by the corporation in the next round, the corporation will find it difficult to secure interest from unaffiliated investors who may consider it a waste of time and effort to even conduct due diligence once they are informed about the right. This will likely result in the valuation given to the corporation in the next round of financing being lower than it would be if the corporation could approach and interest more investors. If the corporation does not disclose the existence of the right of first refusal, any prospective investor that performs due diligence, upon discovering the right of first refusal, may seek to hold the corporation liable for misleading the investor and causing the investor to incur expenses. This is particularly true if the prior round’s investor does exercise the right and forecloses the ability of the prospective investor to purchase securities of the corporation.

Solution. If the corporation is going to grant a right of first refusal, the right should be a right of first refusal to purchase only the investor’s pro rata portion of the securities offered (in other words, in an amount that will enable the investor to maintain its percentage interest in the corporation that the investor had prior to the new financing). In effect, this converts the right from a right of first refusal to an exercise of preemptive rights.
• Preemptive rights are rights granted to an investor that enable the investor to purchase sufficient securities in subsequent rounds such that the investor will be able maintain its percentage ownership of the corporation on an ongoing basis. Preemptive rights can be time limited or can be granted with respect to a limited number or amount of financings. For example, the corporation could issue preemptive rights that expire when the corporation raises an additional $10 million in financing or upon expiration of two years from the date of the initial financing.

There are two principal issues with respect to preemptive rights:

• First, if the preemptive rights are granted only to an investor and the corporation undertakes two or three additional rounds of financing, the investor's ownership interest will remain undiluted if it exercises the preemptive rights. In this fashion, the investor almost has an equivalent to an anti-dilution right, the only difference being that the investor will pay an amount equal to the price per share paid in each subsequent round if it exercises its preemptive rights. Unless management and the founders also have preemptive rights, the problem with this scenario is that the investor that owns 25% of the corporation at the end of the first round will still possess that percentage after three rounds, and the management and founders may have lost effective control as their ownership is diluted.

• Second, if the management and founders negotiate for preemptive rights equivalent to those granted to an investor, these rights may prove to be illusory if the pricing of subsequent rounds increases substantially. In other words, unless management and the founders have significant personal resources, they will be unable to maintain ownership parity with the investor that can afford to continue to exercise preemptive rights as they become available for exercise.

Solution. Avoid preemptive rights altogether but, where that is not possible, management should seek to impose dollar limitations or time limits on preemptive rights. If this proves unworkable, the management team might consider negotiating for the grant of additional options that would become exercisable only if an investor later exercises preemptive rights. If these are incentive stock options, there will be no tax implications for management on option exercise and the life of the options may be long enough to provide some meaningful dilution protection to the management team. This protection will obviously be enhanced if the options contain language that permits a cashless exercise.

Defaults, Indemnities or Hold Harmless Provisions, and Remedies

Equity and debt financing agreements differ markedly in the treatment of a default. In a debt financing, the occurrence of an event of default will trigger a notice from the lender and, if the event of default is not cured, the
lender will accelerate the obligation in its entirety. Defaults in debt financ-
ings are classified as payment or non-payment defaults, with payment
defaults typically having shorter notice periods and opportunities to cure
than a non-payment default. Although breach of a representation or war-
ranty is a non-payment default, most non-payment defaults are covenant
violations such as:

- Default in payment, or acceleration, of other loan obligations;
- Transfer or sale of collateral without the lender’s consent;
- Bankruptcy, reorganization, and similar proceedings;
- Loss of licenses or permits necessary to operate the business;
- The entry of a judgment that remains unpaid or unappealed for a des-
ignated period of time;
- Entry of consent orders or other regulatory action that adversely
impacts the business;
- A change in control, sale of assets, merger, acquisition, or similar trans-
action; and
- Noncompliance with financial and net worth ratios.

Once a default is declared and is not cured within the notice period, a
lender typically retains broad power to take possession and dispose of collat-
eral, foreclose on real and personal property, and may even have rights to
operate the business pending its liquidation and wind-up. This is the primary
reason why notice and cure time periods are so important to a borrower.

Lenders typically negotiate for and are given broad indemnity from
the corporation for any damages and costs of all legal actions and arbitra-
tion proceedings that are related in any manner to the loan. The only
exceptions to this indemnity are any action undertaken by the borrower to
enforce the loan documents or the lender’s gross negligence or willful mis-
conduct. In addition, even if the corporation does not own real property, the
lender will almost always secure a broad environmental indemnity that
relates to the owned or leased property of the corporation.

“Default” is not a concept compatible with equity financings and reme-
dies for a so-called “default” are usually quite limited as compared to those
afforded a lender. If an investor determines after a closing that a repre-
sentation or warranty was not true, the investor’s recourse might be
limited to bringing the untrue statement to the attention of the board of
directors and seeking to have the responsible officer terminated for cause.
Because the law in some states does not permit removal of a director by the
board even with cause, the removal of a director may not be accomplished
without a stockholder vote. If the untrue statement was the subject of an
opinion or report by an expert, the investor might have recourse against
the expert. In all likelihood, however, the investor will be forced to seek a
negotiated resolution or initiate a legal action or arbitration to effect any recovery. This is one of the reasons that investors seek and obtain higher rates of return than lenders, and also emphasizes that the investor is much more dependent on due diligence (other than collateral audits) than a lender.

It is interesting to note that the equity investor making the investment that is the subject of Appendix H elected to enter into an indemnification agreement with the corporation that obligated the corporation to indemnify the investor—but only as to third-party claims (see Appendix H, page 233). Thus, the investor is not indemnified from covenant violations or breaches of representations and warranties by the corporation itself. This is common sense given the fact that an indemnity from the corporation may be meaningless to the investor if the investor's own funds in the corporation are the sole source of recovery. It would not be unreasonable to question the value of an indemnity agreement such as that appearing in Appendix H, especially in view of the fact that the investor probably has a net worth that far exceeds that of the corporation and any third party asserting a claim would ultimately be looking to the investor if the corporation has limited resources.

**Penalty Clauses**

When speaking of remedies in an equity financing, the most common form of remedies are penalty clauses. These clauses can take several forms:

- Adjustments to the conversion rate of preferred stock or convertible debt, or adjustments to exercise prices or terms of warrants issued in conjunction with an equity financing, that give the investor an increased ownership percentage of the corporation if the management team fails to exceed pre-established performance benchmarks or if the investor's shares are not registered on a timely basis;
- Voting trusts or irrevocable proxies that grant the investor voting rights over management stock if the corporation does not meet performance benchmarks;
- Imposition of super-majority voting requirements that give holders of preferred stock a veto power over most, if not all, corporate decision-making;
- Any debt instruments that were issued in conjunction with equity may provide for increases in the interest rate or acceleration upon the occurrence of specified events;
- An automatic increase in the size of the board of directors on the occurrence of specified events that give the investor control of the board of directors; and
- Loss of unvested options or shares issuable under a claw-back if vesting or performance criteria are not met.
Penalty clauses must be carefully reviewed and negotiated as a change in control or significant loss of value in stock or options can have an enormous impact on the management team and/or founders. When tied to financial performance in particular, management should analyze worst case scenarios, including an inability to secure the next round of financing, in order to determine what degree of control or value would be lost in such event.

**Preparation of Disclosure Schedules and Exhibits**

As the management team and the corporation’s professionals continue their negotiation of the purchase agreement with the investor or lender, the management team must begin to develop schedules and exhibits to disclose exceptions, the vast majority of which will be exceptions to representations and warranties. While occasionally a covenant may be qualified by an exception, these exceptions are normally written into the covenant and not disclosed separately on a schedule. For example, if the corporation is a Subchapter S corporation and has covenanted that it will not make any distributions to stockholders except for distributions necessary to allow the stockholders of the corporation to pay their taxes, that exception will normally be written into the covenant. Therefore, when dealing with disclosure of exceptions, the management team will be devoting a significant portion of its time and effort to preparation and evaluation of the disclosure schedules related to exceptions to representations and warranties.

**What Is an Exception and Why Is It Important?**

If one thinks of representations and warranties as a protective layer of clothing, an exception would be akin to a hole in the clothing that exposes the wearer to the elements and thus draws attention to the lack of a protective covering. In a financing, the existence of an exception is important because it draws the attention of a lender or investor and usually causes the investor or lender to conduct additional due diligence about the reasons for the exception. In extreme cases, the investor or lender may ask the corporation’s counsel or the investor or lender’s own counsel to render an opinion on the issue to provide the investor or lender a level of comfort about the exception. Although exceptions are necessarily entity-specific, there are certain exceptions that seem to appear more often, such as:

- Existence of litigation in which the damages claimed exceed the dollar limitation for what the parties consider to be immaterial claims;
- Existence of income, sales, use, or personal property tax audits or outstanding appeals regarding the same;
- Material changes in liabilities, assets, or debt that exceed the dollar limitations in the representations and warranties;
• Any use, storage, or disposal of substances or products that are hazardous or regulated under environmental laws;
• Contracts exceeding dollar limitations and related disputes, defaults, and enforcement; and
• Amounts listed on accounts receivable that are disputed, denied, or subject to set-off.

Exceptions are extremely important in that (1) they will trigger additional inquiries and due diligence, (2) once disclosed, they could cause a lender or investor to reconsider funding, and (3) provision may be made in the financing documents for an adjustment in ownership percentages (equity financing) or additional interest or reduced borrowing availability (debt financing) if the exception ultimately is resolved in a manner unfavorable to the corporation. For these reasons, the management team should be very focused on “managing” disclosure so as to minimize, to the extent possible, the impact of the exception on the investor or lender.

**DISCLOSING EXCEPTIONS: THE WHEN AND THE HOW**

The cardinal rule when dealing with exceptions is “avoid surprises at all costs.” Preparedness for all disclosures is key for management’s responses to be credible.

Likewise, under no circumstances should management adopt the approach of “caveat emptor” and wait for the investor or lender to discover the prospective exception during due diligence. In instances where this occurs and the exception is significant or may have a material adverse effect on the corporation if resolved against it, the investor or lender will usually feel they have been “sand-bagged.” As a result, the investor or lender will terminate the letter of intent or preliminary commitment, or advise the corporation that a term sheet is no longer valid. More damaging are situations where the investor has already executed a definitive agreement that has a “due diligence” out. In this scenario, the termination often occurs near the time anticipated for closing and the damage to management morale, not to mention the financial implications, can be extreme. Even if confidentiality agreements have been executed, once word leaks out that a bank or investor backed away from a transaction, the corporation may also be hard pressed to easily identify and secure an alternate source of financing.

Perhaps the most difficult issue to deal with in preparing disclosure schedules is when the corporation itself, the lender or the investor discover during due diligence, and for the first time, a matter that will constitute an exception. This is indeed a tender moment, as the future of the financing transaction may hang in the balance and the outcome may well depend on
how management responds. Although generalities in such a situation are rare, many investors or lenders will use such a situation to “take the measure” of management. If the issue discovered is immaterial, then schedule disclosure will not be required and the investor or lender will expect management to be responsive although not overly concerned. On the other hand, if the issue is material, the investor or lender that does not immediately exit the transaction may well be interested in judging how management responds to a crisis situation. Thoughtful and reflective analysis of the issue, consideration at the appropriate level of management, and implementation of an action plan to appropriately address the issue mean more at this time than perhaps at any other in the corporate life cycle.

Counsel to most venture and private equity groups will prepare a cover page for exception schedules that stipulates that disclosure of an issue on one schedule does not constitute disclosure on any other schedule that is attached to the purchase agreement. While counsel to the corporation may seek to reverse this clause, most investors and lenders insist upon separate disclosure of any exception. When faced with this clause, management and the professionals are well advised to review each exception and all relevant representations and warranties so that the exception is repeated wherever appropriate. Though this may seem to be a waste of time, there is little to lose by repeating known information in multiple schedules.

**Practice Tip.** One very practical way to deal with a prospective exception that the management team knows will surface in the course of time is for management to discuss the issue with the investor or lender well before the investor or lender ever sees the first draft of the schedules. This is proper “management” of the disclosure and will (or should) eliminate the possibility of surprise when the exception appears on the schedules. This does not mean that management must “bare its soul” at the first meeting with a prospective investor or lender, but does mean that a discussion should be held about the issue when the relationship has advanced and a logical opportunity for disclosure presents itself.

**Public Offering Disclosure**

The corporation that prepares and files a registration statement for a public offering is subject to due diligence by a number of parties, including its own counsel, its auditors, the investment banker, the investment banker’s counsel and, to a limited extent, the Commission and the exchanges. Neither the Commission nor the exchanges have due diligence obligations. However, with the broad availability of information over the Internet and the role of the exchanges as “gatekeepers,” both the Commission and the exchanges have taken a more “activist” role in questioning disclosure and monitoring public information about companies that are in registration. To
some degree, this regulatory response has developed from the perceived and actual use of the Internet to convey information to investors outside of the prospectus that may increase the market's appetite for an offered security. The corporation that is undertaking a public offering should carefully "scrub" and update its Web site, eliminate any questionable hyperlinks, and review disclosure and Web site information to eliminate inconsistencies well before any filings are made.

When undertaking a public offering, the corporation generally executes the underwriting agreement on or soon after the effective date of the offering. The underwriting agreement is negotiated with the underwriters well in advance of this time. Just as with purchase agreements and other documentation covering equity financings, the underwriting agreement contains representations and warranties of the corporation, covenants, indemnities, and the terms under which the investment bankers will purchase securities from the corporation. Instead of the representations and warranties requiring separate disclosure schedules or exhibits, the underwriting agreement usually states that the representation or warranty is made on an unqualified basis except as otherwise disclosed in the prospectus and registration statement. In this fashion, the prospectus and registration statement serve dual purposes: full disclosure to investors and highlighting an exception from a representation and warranty set forth in the underwriting agreement.

In general, underwriting agreements contain many of the same types of representations, warranties and covenants that any other equity financing document contains. The management team and its professionals will therefore focus on qualifying representations and warranties and limiting covenants by dollar amount, time or other means. Material exceptions will be the subject of disclosure in the prospectus, and referenced in the underwriting agreement as appropriate. In some instances the underwriting agreement will state that the corporation is in compliance with the applicable representation or warranty "except as disclosed in the prospectus." Hence, this provision addresses the fact that the disclosure of the exception has been provided in response to the contract's requirements (that is, the underwriting agreement) and, if no disclosure appears on the subject matter in the prospectus, the investment banker will assume that there is no exception to the representation or warranty. If the investment banker is aware of facts to the contrary, the banker must take steps to assure that the matter has been given proper due diligence and, if disclosure is called for, that it has been provided.

The consequences of a failure to disclose information in the context of a public offering are far greater than those associated with a failure to disclose in a private financing. First, officers and directors who sign the registration statement are strictly liable for what appears in the registration
statement and they have no due diligence defense. In the context of a private financing, proving knowledge of a particular fact, and the existence of a duty to disclose, is required before liability may be imposed. Also, a failure to disclose in the public offering will raise the prospect of class action lawsuits, regulatory action by the SEC or exchanges, and generally will carry far greater financial implications than when disclosure does not occur in a private financing. Although this should not be interpreted as a license to be less rigorous in developing disclosure schedules and exhibits in a private financing, the fact of the matter is that public offering disclosure has far wider dissemination and potential for creating liability than the disclosure provided in a private financing.

One point that bears mention, and that is different from other forms of financing, is that the underwriting agreement provides extremely broad protection to the investment bankers in the form of indemnity and contribution rights. The underwriting agreement typically states that the corporation will indemnify the investment bankers for every statement in the registration statement except information provided to the corporation in writing by the bankers. The underwriting agreement typically states that the only information provided by the bankers is the price of the shares, the names of the investment bankers, and the name of their counsel. As a result, a failure to disclose that exposes the investment bankers to liability will usually trigger a claim for breach of contract against the corporation by the investment bankers (since the underwriting agreement is really just a contract to purchase securities of the corporation) and a claim for indemnity for damages and expenses from the corporation.

If indemnity is unavailable to the investment bankers for any reason, the underwriting agreement usually provides for contribution by the corporation and the investment bankers to any damages or expenses incurred by them. The measure of contribution is generally the amount of money received by the corporation (the net proceeds of the offering) and the amount received by the investment bankers (usually the commission and expense allowance). The result, of course, is that claims for contribution will most often favor the investment bankers and leave the corporation with the vast bulk of exposure for a failure to provide proper disclosure. Many would argue that this is appropriate given the fact that the prospectus is the corporation’s document, not the investment bankers’. This ignores, however, the due diligence obligation of investment bankers and their counsel, which cannot be shifted to third parties. Due diligence is also a defense available to investment bankers and counsel, whereas the corporation has no such defense available to it.

Unfortunately, indemnity and contribution clauses are rarely the subject of significant negotiation in an underwriting agreement because the investment bankers hold these provisions as sacrosanct and unalterable. The
management team will usually be better to focus on the quality of disclosure in the prospectus rather than attempting to limit the corporation's exposure by seeking to limit the broad reach of indemnity and contribution clauses.

**Summary**

The principal provisions of most equity and mezzanine financing documents are similar in that they address historical information through representations and warranties, forward-looking information through covenants, and disclosure exceptions in schedules, exhibits, or full scale disclosure documents such as prospectuses. Loan agreements generally focus attention on affirmative and negative covenants that extend for the life of the loan or until specified goals are achieved. Indemnities are customary in both equity and loan documents and will almost always be non-negotiable to a significant degree. The management team must be wary of penalty clauses, rights of first refusal, preemptive rights, and any special indemnity or contribution language and, where possible, seek to limit the scope or application of such rights or clauses. If non-negotiable, “forewarned is forearmed” may be the only way for management to consider and react to these types of provisions.

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**Case Study: Client Meeting Preparation**

Clients are now proceeding toward a final agreement with an investor. The proposed agreement has brought up issues they hadn't previously discussed with you. They have requested an advisory meeting to discuss the proposed agreement in more detail and get your input on items they should be wary of as the negotiations continue. Here are some common questions and scenarios derived from the Chapter reading. How would you respond?

**Situational Analysis**

1. How should a corporation seek to limit the effect of negative covenants?

**Practitioner Response:** The effect of negative covenants can be limited by (1) permitting transactions or events to proceed if they fall below a predetermined dollar threshold, (2) using generalized materiality thresholds, and (3) imposition of notice requirements to allow the corporation time to respond to a situation or cure an impending default.
2. What is a PIPE? What type of investor would you expect to participate in a PIPE?

Practitioner Response: A PIPE is a Private Investment in a Public Entity. PIPEs are customarily funded by institutional investors and usually consist of common stock or mezzanine financings with attached warrants.

3. If you are part of a management team and are involved in negotiating an equity investment with an outside investor, how would you seek to build flexibility into the representations, warranties and covenants given by your employer so as to avoid an early or unintended default?

Practitioner Response: Building in flexibility means using materiality thresholds, qualifying language, dollar thresholds, and notice provisions to give the corporation some “elbow room” to conduct its operations without having to refer back to the investment documents every other day to ascertain if it must notify the investor or lender about an issue. Notice provisions buy some time to respond to unanticipated events and are therefore critical in establishing flexibility.

4. What types of indemnities should a corporation expect to give to a lender? To a private equity investor? In a public offering?

Practitioner Response: The corporation should expect that lender indemnities will be extremely broad and will carry special environmental provisions. Private investors will generally look for similar broad indemnities, but sometimes will only be concerned about third-party claims, as opposed to claims against the corporation. Unlike lenders, however, investors assume no environmental risk and will not appear in the chain of title, meaning that private investors do not usually insist on the same type of broad environmental indemnities as will a lender. In a public offering, the corporation should expect to indemnify the investment bankers for what appears in the prospectus and the representations and warranties in the underwriting agreement, except what the investment banker provides to the corporation in writing. This is usually specified as what appears in the “Underwriting” section of the prospectus and the name of the underwriter’s counsel under “Legal Matters.”
5. When faced with an investor seeking preemptive rights to acquire later-offered securities, what alternatives or limitations should the corporation consider requesting?

**Practitioner Response:** The alternatives or limitations that the corporation should seek include (1) a grant of equal preemptive rights to management and the other stockholders who currently own shares, (2) a dollar limitation in the quantity of securities that can be purchased using preemptive rights, (3) a time limitation on how long the preemptive rights remain in existence, and (4) rights to grant options, the vesting of which would relate to any exercise of preemptive rights. If the corporation intends to conduct debt financing, it might seek to negotiate for an exception for warrants from the triggering provisions of the preemptive rights. This could be limited to those circumstances in which the warrants carry an exercise price of greater than the amount at which common stock was last sold.

6. When faced with exceptions that must appear in schedules or exhibits, what are some general rules to follow about when and how to disclose the subject matter to a prospective investor?

**Practitioner Response:** The best rule is to disclose early in the financing process. Another good rule is to have done all the necessary due diligence on the issue that is the subject of the exception so that a complete disclosure package can be furnished to the investor on request. Other rules include avoiding surprises, avoiding an over-reaction to an exception, and making sure that exceptions are mentioned in each and every schedule or exhibit as to which they apply.

7. How is an underwriting agreement for a public offering similar to a stock purchase agreement with an institutional investor? How is it different?

**Practitioner Response:** The underwriting agreement and the purchase agreement are very similar in the types of representations and warranties each provides to the investor or investment banker. Generally speaking, the covenants are also quite similar, although a purchase agreement will typically have a greater number of covenants relating to disclosure and reporting which, for the newly public company, is governed by the Securities Exchange Act of 1934. The indemnities are usually more significant and far reaching in the underwriting agreement since the liability associated with the public offering is considerably greater and the investment bankers always will seek to impose that liability on the corporation. Exceptions to the purchase agreement appear in schedules and exhibits, while exceptions in the underwriting agreement are usually disclosed in the prospectus.
Once the small business corporation is funded and enters the post-closing period, the management team must focus on managing the relationship with the financing source for optimum results. This typically means that the corporation must fulfill its reporting obligations, make an effort to keep the investor fully informed of material positive or negative events and, oftentimes, lay the groundwork for the next round of financing. How the corporation succeeds in this endeavor is likely to have a critical impact on existing or future investors making a commitment to provide additional funding. The well-prepared management team knows that prospective investors conducting their due diligence usually interview existing investors and that the perceptions of existing investors may carry inordinate weight with prospective investors.

The Bottom Line. Although every business encounters difficulties in the course of its existence, it is how management responds to these difficulties and manages its relationships with financing sources through such periods that may well determine the ultimate success or failure of the business.

It is also during the post-closing period that management must begin to develop a strategic plan for refinancing maturing debt obligations and securing funding for redemption of preferred stock or warrants that carry redemption rights. Since redemption obligations are usually extinguished or discharged if the corporation completes a public offering or sale transaction, management may be required to consider just such a liquidity event unless cash flow from operations is sufficient to fund the redemption or other forms of financing become available. Corporations that face such investor-imposed
deadlines are well advised to develop multiple financing options where possible in order to have a back-up plan available in the event that changing market conditions or industry circumstances close a particular “liquidity window.” This is especially true where the investor has coupled the failure to obtain liquidity with a penalty clause that reduces management’s control over the business, expands the investor’s ownership, or increases interest expense or the redemption premium by a punitive amount.

THE CORPORATION’S REPORTING OBLIGATIONS

In equity financings other than public offerings, and in mezzanine debt financings, the corporation is typically subject to affirmative reporting covenants such as those covered in Article IV of Appendix L, “Subordinated Loan Agreement.” In larger financings, the required communications generally include:

- Monthly, quarterly, and annual financial statements;
- Management letters and audit reports;
- Financial covenants compliance statement;
- Notices of defaults, non-payments, suits, subpoenas, orders, lapses of licenses or permits, or any events that would have a material adverse effect on the corporation;
- Copies of reports to stockholders and government bodies, including reports filed with the SEC, tax returns, and pension-related filings;
- Notices of newly formed, new contributions to, or termination of, pension plans, or notices from tax authorities regarding pension plans;
- Notices of changes in location, property, assets, key members of management, or events outside the ordinary course of business; and
- Updated projections.

The reporting requirements in a straight equity offering may be considerably less onerous than those described above, as one can see by comparing the covenants set forth in Section 3 of Appendix M, “Investors’ Rights Agreement,” with those in Article IV of Appendix L. The principal similarity is that a straight equity financing requires the same type of financial reporting as that given to a mezzanine lender, together with enhanced financial reporting to “major investors.” The primary reason for the less burdensome reporting covenants set forth in Appendix M is that the investors in that transaction were granted the right to appoint a representative to the board of directors, as described in Section 3.5. Because the board of directors would presumably be aware of any of the events otherwise subject to reporting covenants, the investor’s membership on the board of directors obviates the need for more comprehensive reporting.
Sizeable revolving credit lines impose most, if not all, of the same reporting requirements on the corporation that appear in Appendix L. Additionally, the corporation is usually obligated to provide monthly collateral reports such as accounts receivable aging, inventory certification, and eligible borrowing calculations based on such reports. The corporation may also be required to have outside firms perform collateral audits on an annual basis, or more frequently if industry conditions are in flux. Smaller revolvers often have more circumscribed reporting requirements that may be limited to compliance with financial ratios, collateral certifications, and provision of periodic financial statements.

The reporting requirements imposed on public companies derive from the Securities Exchange Act of 1934. These reports can be summed up as follows:

- Quarterly reports on Form 10-Q or 10-QSB;
- Annual reports on Form 10-K or 10-KSB;
- Proxy statements, information statements, and “glossy” annual reports to stockholders;
- Reports of current events on Form 8-K, including events reportable pursuant to Regulation FD; and
- Reports of individual directors, executive officers and principal stockholders such as Forms 3 and 4, Schedule 13D, and 144 notices of sale.

The reporting requirements imposed under the Exchange Act continue in effect for so long as a company remains registered under the Exchange Act. This is true whether the company becomes a reporting company as a result of completing an IPO or by filing a Form 10 registration statement under the Exchange Act. A company can de-register under the Exchange Act by filing a Form 15 once it (1) has less than 300 stockholders, or (2) has less than 500 stockholders and had total assets of less than $10 million as of the end of the three most recent fiscal years. Of course, once a company de-registers under the Exchange Act and ceases filing periodic reports, it will not meet the listing requirements of the exchanges or Nasdaq and its securities will no longer be eligible to trade on an exchange or Nasdaq. The reporting requirements imposed on directors and executive officers continue for so long as such persons hold their respective positions and until they have not been affiliated with the corporation for a period of 90 days thereafter. If such persons continue to exercise control (by shareholdings or otherwise) or own more than 10% of the outstanding stock of the corporation, they will continue to be subject to the reporting requirements imposed on principal stockholders until they no longer can exercise control or own less than 10% of the outstanding shares.

It is self evident that timeliness in meeting reporting obligations imposed by financing sources or the Exchange Act is crucial to establishing and maintaining the corporation’s credibility in the financing markets.
Failure to do so will diminish management's integrity and cause investors and creditors to question the very survival of the corporation. This is not to say that an occasional request by management of a private company for additional time to complete an audit or reporting function will be denied. However, the greater the frequency of the request, the greater the chances that the corporation will begin to lose trust. Public companies can request an extension of time for filing of a 10-Q, 10-QSB, 10-K, and 10-KSB by filing a Form 12b-25 with the Commission. The extension is limited to five days for quarterly filings and 15 days for annual filings. Whether or not misguided, many analysts have taken the position that a late filing, even if completed within the time period permitted by a 12b-25, is an indication of some difficulty in preparation of financial or other information and have advised their clients to sell their shares in public companies that file for an extension of time. With fast closings now common among most public companies, there may be some logic to the position taken by these analysts, although in some instances a strict "sell" rule could penalize a company that is unable to make a timely filing for a myriad of other reasons. Hence, timeliness of filing Exchange Act reports is made all the more important when considering the implications for the corporation if several analysts suddenly change their recommendations to "sell."

Investor Relations Is Especially Important for Private Companies

When one thinks of the term "investor relations," it often brings to mind the use by the corporation of a public relations firm to disseminate press releases and press kits, and to help design and present "roadshows," to investors, market makers, journalists, and broadcast media. Investor relations may also encompass the more generalized effort associated with creation and reinforcement of a favorable public image for the corporation and its products or services. Although a private company may retain a public relations firm for these more general purposes, it is rare for a public relations firm to be engaged in investor relations until after a public offering. This is typically a cost-related decision and is not incorrect. Nonetheless, the management team cannot forget that during the earlier stages of the corporate life cycle, the officers and directors will carry the burden of "investor relations" and that the creation or inability to achieve good investor relations may have a direct and substantial impact on the success or failure of the corporation. Put another way, receipt of the funding is not when the job is done; rather, that is when the job begins.

Here are some low cost suggestions about good investor relations practices that private companies may want to consider, even if an investor representative attends board meetings:
• Send monthly or quarterly updates to all investors by e-mail;
• Send press releases announcing new products, customers, additions to the management team, and similar events to investors by e-mail;
• Provide investors with overviews of industry developments in e-newsletters;
• Hold open houses and invite investor principals and associates;
• Provide Web casts or videoconferencing question and answer update sessions;
• Forward copies of news, magazine, and trade articles to investors that concern the corporation; and
• Obtain customer testimonials and consents to use the testimonials in e-newsletters.

DEALING WITH THE INEVITABLE: NEGATIVE INFORMATION

In each corporation's life, there will come a time when the loss of an important customer contract, competitive development, supply chain interruption, cost increase, or similar event will occur. The management team is often caught between the desire to prevent undue damage to the corporation from the event, particularly if the ramifications are not yet known, and the need to avoid "springing" the information on investors who are unprepared for a negative event that may have a significant adverse effect on the business. As is the case with due diligence, the need to avoid surprises must be kept uppermost in the minds of the management team, since presenting an investor with information "after the fact" can undermine the investor's trust and faith in the management team. If the investor is going to be asked to participate in future financing rounds, or if the investor is likely to be interviewed for due diligence purposes by other potential investors, the investor should be accorded a high degree of respect and access to information. This will reinforce the perception that the management team is open to input from stockholders, is willing to share information with stockholders, and operates in an open communications environment. In some respects, operating in this manner will prepare the management team for what life will be like when operating a public company.

Dealing with lenders is somewhat different than dealing with equity investors. Straight debt lenders do not have an interest in the business and therefore are not entitled to receive some information that might be both material and disclosable to equity investors. In many circumstances, the loss of a key customer or competitive developments would not trigger any type of notice requirement under applicable covenants. The management's analysis should not, however, stop at the question of whether or not disclosure is required. Like the equity investor, bankers hate surprises. If the management team knows of a development early in the fiscal year that
likely will have a detrimental effect on financial covenant compliance later in the year or early in the following year, the management team is well advised to open communications with its senior lender well before the corporation goes out of covenant compliance. This allows time for renegotiation or waiver of the relevant covenant or, in the worst case scenario, the corporation may be advised that its loan availability will be reduced. If this happens, the corporation that has taken up the subject with the lender early in the process may at least have time to secure a new lead bank or a supplemental source of financing if one is necessary.

In the public company setting, prompt disclosure of negative developments is not only required, but is also good business. The management team that learns of negative information and that fails to release this information publicly may expose the corporation and members of the management to liability for the failure to promptly disclose. This liability can take many forms: an enforcement action by the SEC seeking civil or monetary penalties, insider trading, violations of Regulation FD, class action lawsuits, individual lawsuits, whistle-blower lawsuits, and perhaps even criminal sanctions. In some cases, the failure to disclose negative information could trigger a broad spectrum of liability under several of the foregoing theories, such as when the corporation does not disclose information, except to one analyst (a violation of Regulation FD), an officer trades while knowing the information (insider trading), and when the information comes out, the SEC commences an enforcement proceeding and the plaintiff's bar brings a class action lawsuit.

With Harvey Pitt now chairing the SEC, it is likely that some rule-making will take place under which the SEC will require companies to provide real-time disclosure of negative (as well as positive) information using the Internet and available technologies to achieve broad, instantaneous dissemination of company-specific information. If adopted, this type of rule will make Regulation FD obsolete and become the standard bearer for timely corporate disclosure. Should this type of rule be adopted, public companies will need to allocate more resources in the form of management time, professional expense, and careful preparation of meaningful disclosure that will address the more demanding requirements of a real-time disclosure regime.

**DEVELOPING EXIT STRATEGIES TO ADDRESS MATURING FINANCIAL OBLIGATIONS AND LIQUIDITY PLANS**

As the corporation reaches maturity and the management team begins to plan for the future, one of the most important issues that must be considered is how the corporation will achieve liquidity to fund redemption or retirement of subordinated debt, preferred stock, or other securities subject
to mandatory redemption. In a similar vein, if the corporation has been able to previously retire these types of debt and debt-equivalents and has a relatively "clean" balance sheet, the management team seeking some liquidity may be considering taking on this type of financing again in a leveraged recap. Other alternatives, such as the sale of the business, a public offering, or a merger with another firm, may also be discussed. The following material summarizes the positive and negative implications of each alternative and suggests some of the factors that should be evaluated when developing the strategic plan.

**Liquidity Options for Refinancing**

The corporation that faces a maturing obligation is in a fundamentally different position than the company that is considering alternatives for liquidity without a need for that liquidity *per se*. For example, if the corporation must redeem preferred stock in three equal tranches of $4 million each in the following three years or force the conversion by going public or selling the business, the management team will need to evaluate:

- The condition of the market for IPOs, both generally and within its industry;
- Valuations in the private and public markets based on recent transactions;
- The identity of likely purchasers of the business, their potential interest, and their ability to pay an acceptable purchase price;
- The possibility that economic conditions or industry-specific factors will affect the business or its valuation both in the near future or within the three-year redemption period;
- Availability of refinancing and its cost, both in dollar terms and perhaps in the value of any equity issued in connection with the refinancing;
- The time that will be required to conduct an IPO, sale, or refinancing;
- The state of relations with existing stockholders, their need for liquidity, the likelihood of securing an extension if alternative financing is not immediately available, and the cost of an extension;
- The impact of penalty provisions that will increase the effective cost of failing to retire the securities subject to redemption; and
- Whether cash flow from the business will be sufficient to pay down all or a portion of the redemption obligation.

The last factor is clearly the most important, since the corporation that has access to cash flow in an amount sufficient to retire the obligation will likely have other attractive alternatives from which it can select. However, more often than not, a more significant source of liquidity may be required because cash flow is optimally used within the business, rather
than so plentiful as to permit the early retirement of substantial portions of debt-equivalent equity.

The first step after reviewing the available alternatives and the factors identified above should be to make a rational appraisal of which options are likely to be unavailable to the corporation, thus narrowing the possibilities to a targeted group with a realistic chance of completion. If the corporation is in the distribution industry, for example, the management team should know that few distributors succeed in an IPO without having attained some considerable size. On the other hand, if the corporation has several products that are achieving good market acceptance and that have little competition due to possession of patents or exclusive licenses, an IPO may be viable if the market conditions indicate that a window exists. Even if a window exists, other factors may impact the decision of whether to pursue an IPO, such as the age of the management team, the need to attract highly qualified employees, or valuations of the corporation’s competitors in the public market. A management team looking toward retirement is more likely to consider an outright sale of the business, particularly if the sale can be accomplished for cash or a combination of cash and stock, rather than an IPO.

Once the more desirable options are identified, the management team must develop a rationale for comparing the relative cost of capital for financing options. This necessitates the management team preparing and delivering a business plan to select financing sources in order that term sheets or letters of intent can be secured and evaluated. While general discussions may be helpful in establishing expectations, the management team must anticipate that terms will change once potential investors conduct due diligence and determine the offer they are willing to make. If the term sheets call for the issuance of warrants or other securities, the management team will need to compare such items as exercise price, exercise period, redemption terms, and other factors to the terms of the existing financing (if extendable) and other financing alternatives. Interest expense, penalty clauses, and the time cost of capital will also need to be considered.

It is not uncommon for the mature corporation to have very limited options for financing/refinancing if its recent performance has been poor, while the corporation with outstanding performance is often graced with the luxury of having a multitude of financing/refinancing alternatives. Hence, if the corporation has not had strong results in recent periods, it is often a good idea for the management team to allow time to explore more alternatives or to solicit proposals from a higher number of prospective investors. The corporation with strong results should consider the available low cost capital alternatives such as bank term debt, securitizations, issuance of rated debt, and commercial paper facilities in order to capitalize on its operating strengths.
Liquidity Options Without Refinancing

The principal means of generating liquidity for the stockholders of the corporation that do not need to refinance prior obligations are a sale of the business for cash, merger into a larger public organization, and an IPO. Each of these options has positive and negative aspects for the management team to consider.

Sale of the Business for Cash

Some of the advantages and disadvantages of this option are as follows.

• If liquidity is king, this option is superior to all others.
• A private corporation sold for cash, absent extenuating circumstances, will almost always be sold at a valuation less than that accorded a public company in the same industry. Typically, private corporations will change hands at multiples of 3x to 5x EBITDA, while the public company may be trading at 9x to 12x EBITDA. Although sale and trading ranges are obviously entity and industry specific, the general rule that the private company will bring less than the public company is almost invariably true.
• A sale for cash offers the stockholders the ability to diversify their net worth among a variety of assets, as opposed to holding stock in a larger public entity or holding restricted stock after an IPO.
• The scope of indemnities and the amount of purchase price holdbacks tend to be greater in an all-cash sale transaction.
• Tax consequences can be significant and adverse in a cash sale, as opposed to the tax deferral that can be accomplished in a tax-free merger or exchange transaction.
• If the founders or management team have to stay on for a period of time to obtain release of purchase price holdbacks, or to receive the earn-out portion of the purchase price, the founders or management may find it difficult to work under management of the acquirer, may be deprived of the resources necessary to achieve targeted results, and may fracture the relationship with the acquirer.

Merger Into a Larger Public Entity

This option presents the corporation with a number of possibilities to consider, among which are the following.

• The acquirer may be able to pay a premium to the corporation’s stockholders based on the relative difference in trading multiples for the two entities. For example, if the target (smaller) entity is trading at a mul-
tiple of 10x EBITDA but the acquiror is trading at a 13x multiple, the
acquiror can afford to pay a premium of 11.5x and still add to its earn-
ings per share. Thus, the target corporation may realize its greatest
enterprise value in this type of transaction.

• If the prospects for the acquiror are enhanced by the acquisition or by
conditions in the industry, holding stock in the acquiror may make as
much sense, or more, than holding stock in the target corporation.

• In a tax-free merger, the tax consequences are deferred, perhaps indefi-
nitely. The recipient of the acquiror’s stock may be subject to limitations
in the ability to make sales for one year or more, meaning that liquidity
may remain a somewhat distant hope. The use of hedging strategies,
exchange funds, and instruments such as zero premium collars and
variable prepaid forward contracts may, however, allow the stockholder
to lock in some current liquidity and diversify his/her net worth without
incurring immediate tax consequences or destroying the tax-free nature
of the merger or exchange.

• Loss of control and an inability to affect the operations of the acquiror
may leave the founders and management of the target corporation feel-
ing frustrated, powerless, and at the mercy of events outside of their
control. This may be difficult to accept for management teams and
founders that have long-time associations with the target corporation.

• If the target corporation is public, the time necessary to complete a
merger between two public companies, and the attendant expense, will
be significant. Regulatory complications such as antitrust reviews,
Hart-Scott-Rodino filing reviews, and international regulatory
approvals can significantly increase the time required to complete the
merger or can even cause the termination of the transaction in the worst
case scenario.

Initial Public Offering

This option presents the management team with a host of issues to con-
sider, including the following.

• The IPO establishes a public valuation for the corporation without loss
of control.

• Proceeds of the offering can be used to grow the business, increasing the
enterprise value without the interest or equity give-up that comes with
debt financing or venture capital.

• Stock sales in the offering itself, sales using the over-allotment option,
debt repayment, sales under Rule 144, hedging strategies, and partici-
pation in exchange funds can offer liquidity to the stockholders with the
potential to increase returns over time if the corporation is successful in
executing its strategic plan.
• No immediate tax consequences from increase in value; favorable tax treatment for incentive stock options; possibility of Subchapter S corporation distributions of accumulated and undistributed earnings at time of IPO.
• Stock options can be used to recruit and retain key employees, reward management, offset to a limited degree the dilution experienced in the IPO, and provide another vehicle for liquidity.
• Accountability and disclosure may have a negative impact, or a perceived negative impact, on the management team or founders.
• Pressure to maintain earnings growth on a quarter to quarter basis.
• Higher profile associated with being public; exposure to class action lawsuits, short swing profit liability and insider trading, none of which are a concern for private entities.
• Expense of being public may be considerable.
• Liquidity for management may be capped by volume limitations, lack of a liquid market, pressure from investment bankers and analysts not to sell, or the perception that these issues may become a problem if sales occur.

Leveraged Recapitalization

The leveraged recap transaction is something of a hybrid as it may be used in either a refinancing scenario or one in which liquidity is the primary goal. When used to refinance existing instruments, the leveraged recap would likely be structured as mezzanine debt or debt-equivalent preferred stock financing, with a portion of the proceeds going to retire existing debt or redeem existing preferred stock, and a smaller portion being used to redeem some of the shares held by founders or management. This will result in the management team retaining control but being given the opportunity to generate some liquidity. Likewise, in the case where refinancing is not necessary, the proceeds of the leveraged recap will be used to provide expansion capital or funds for acquisitions, as well as some liquidity for the founders or management. The leveraged recap:
• Is generally faster to complete than an IPO;
• Will not result in the public disclosure and earnings pressure facing a public company;
• Does not result in a loss of control, such as when the business is sold or merged into a larger entity; and
• Provides expansion capital or refinancing proceeds, together with some liquidity for management, at a cost comparable to traditional private equity financings.
Of course, the flexibility offered by a leveraged recap is likely to come at a price. That is, many of the financing sources for leveraged recaps will have targeted rates of return far in excess of traditional lending sources, typically have board representation and perhaps involvement in day-to-day management, and require the founders or management team members who get liquidity to enter into employment, non-competition, and escrow agreements that will penalize them for a resignation or termination that takes place prior to the repayment of the "leveraged" portion of the recap transaction. In the worst case, this could result in management or the founders ceding control of the corporation to the institution that provided funding to accomplish the leveraged recap.

**Maximizing Value—A Few Suggested Strategies**

In considering ways for the corporation to maximize enterprise value, the board of directors of the corporation can establish one or several strategies designed to accomplish this objective. In doing so, the corporation does not have to commit to one strategy alone, but may be able to combine the best of several strategies. For example:

- If the corporation has maximized its use of lower cost debt financing, and a window for an IPO appears available, the corporation may elect to proceed with the IPO to expand the corporation's permanent capital, retire some debt to create additional borrowing capacity, and offer early stockholders some liquidity. Once the corporation has been accorded a public valuation, the corporation may be able to secure additional expansion capital using a PIPE (private investment, public entity) that will come at a lesser cost than if the corporation were private. If additional capital is unneeded and the management team is more concerned about setting the stage for a sale at the highest possible price, the corporation will need to be managed with a view toward enhancing bottom line performance before retaining an investment banker to begin a search for a suitable merger partner. This may mean undertaking a capital expenditure and/or marketing program that matures in two to three years that drives an increase in productivity and sales in the following two-year period. Midway through the two-year growth period, the management team would want to position the corporation to commence the sale process, which would be completed as the corporation's sales and bottom line performance peak.

- There have been a number of examples of corporations that have sought to "shop" themselves to strategic or financial buyers when private and have been unsuccessful in finding a buyer at the right price. In these circumstances, a few enterprising firms have used an IPO filing as leverage to cause a buyer to make an offer before the IPO
is completed. In other words, the IPO filing is made with the ostensible follow-through commitment, but the management team understands that the publicity surrounding the filing of the registration statement, and the public nature of the filing, is bound to bring the transaction (and the corporation) to a buyer's attention. Assuming the buyer realizes that the IPO will only make the corporation more expensive to buy in the long run, and the management team had previously indicated its willingness to sell on the right terms, the buyer with genuine interest may well be motivated to come to the table with an offer in an attempt to preempt the IPO's completion. This scenario is favorable to the corporation as well since the IPO filing will presumably have placed a value on the corporation that, to some degree, the buyer will have to meet or come close to in order for the board to make a determination to accept the buy-out offer. If the buyer fails to do so, the corporation can always elect to proceed with the IPO and revisit the sale process at a later time.

- In the final analysis, the founders and management of the corporation must keep in mind the somewhat different goals of strategic and financial buyers when positioning the corporation for eventual sale or merger with a larger entity. Strategic buyers that are public frequently seek acquisitions that not only add to earnings per share, but that tell a compelling story to the investment community and that demonstrate superior growth rates or earnings. If the corporation has enjoyed superior growth at the expense of earnings, the management team must be able to articulate the reasons behind the results so that management of the buyer can in turn address this issue with its bankers and analysts. If a buyer has a history of high growth and is concerned about maintaining its high growth rate, the corporation with lower earnings may still command a high price or premium based on fulfilling the buyer's growth objectives.

- A financial buyer may be more concerned with how operations could be streamlined in the short term to increase cash earnings and accelerate retirement of debt taken on in the acquisition. While financial buyers are generally going to pay less than strategic buyers, strategic buyers may be more inclined to offer stock as consideration, with the greater risks attendant to stock as opposed to cash.

The analysis of liquidity and refinancing options above obviously excludes more negative outcomes such as bankruptcy, distress sales, or liquidation. These situations are frequently going to be driven by secured lenders and holders of preferred stock that retain rights to collateral or liquidation preferences that permit them to dictate, to a greater or lesser degree, the results of a reorganization or liquidation. More often than not,
corporations forced to deal with these scenarios are going to end up ceding control to the lenders, if survival is an option.

**SUMMARY**

The operating stage or mature corporation, whether private or public, should have strategic plans in place for refinancing of debt and debt-equivalent obligations well before such obligations become due. Planning ahead for refinancing and liquidity options involves the development of feasible alternatives, narrowing the scope of possibilities as more facts and circumstances become known, and ultimately selecting a primary plan, with a suitable backup, that best addresses the goals and objectives of the corporation and its stockholders. Careful consideration should be given to liquidity transactions that will maximize value, achieve tax deferral, minimize the risk associated with any loss of control, and provide appropriate cutoffs of any continuing liability resulting from indemnities and purchase price holdbacks.

* * * *

**CASE STUDY HYPOTHETICAL—YOU ARE THE CFO**

As the CFO of Funtastic Fireworks Corporation (FFC), you have been intimately involved in the management of the company for over 15 years. FFC is a private manufacturer of high quality fireworks sold in the U.S., European Union and Far Eastern countries with annual revenues of approximately $32 million. Results of operation have fluctuated somewhat, as reflected in the numbers below:

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001 (in millions)</th>
<th>2002 Est.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$29.5</td>
<td>$32.7</td>
<td>$31.5</td>
</tr>
<tr>
<td>EBITDA</td>
<td>$ 7.8</td>
<td>$ 9.7</td>
<td>$ 9.0</td>
</tr>
</tbody>
</table>

FFC's management controls 38% of the outstanding shares of the corporation, with approximately 25% held by a charitable foundation that was the recipient of shares from one of the two original founders. The other founder's descendants have approximately 29% of the shares. These descendants are not active in the business and would like to see some liquidity for their shares, which is the principal reason why the CEO has asked you to examine liquidity options for FFC. The founda-
tion would like to achieve liquidity at some point in time, but is in no rush to have a liquidity event. The management team is making a very nice living and all of the senior executive officers are comfortable with maintaining the status quo, but increasing competition from suppliers in China is expected to require FFC to establish a second manufacturing plant in China to lower manufacturing costs. The existing Chinese plant accounts for 46% of production and the addition of a second plant is expected to trim manufacturing costs by approximately 20% overall. The plant will require a capital investment of $12 million, $2 million of which is expected to come from a Chinese partner. FFC believes it can fund the remainder of the capital investment using an existing credit line, but would like to ultimately fund this amount using a more permanent and long term financing arrangement.

You are doing some retirement planning for you and the CEO and are considering ways in which the two of you might realize significant returns from the years of effort both of you have invested in FFC. While neither of you needs cash, there does not appear to be a successor to either of you on the immediate horizon, which causes you to wonder what would happen if one or both of you decided to retire. Although a buyout of either of you would not be impossible, the price of the shares held by you and the CEO is well beyond what either of you can afford individually.

The prospects for FFC are very good for 2003. In fact, sales growth is expected to exceed 20% in the first quarter of 2003 as a result of the Chinese New Year falling on February 1 and being the Year of the Goat. FFC has geared up for large production increases and you feel that sales in the Far East may set a record for the March 31 quarter. Sales in other regions are expected to increase 10% or more in the next year, as industry sales of fireworks have continued a pattern of relatively strong growth.

Two other facts that are known to you currently may impact your thinking as you ponder FFC's options. First, FFC formerly had a plant in Thailand that may have some contingent liabilities related to environmental issues arising from disposal of gunpowder residue. The cleanup is not expected to be expensive, but local officials may insist upon a more extensive cleanup if improper disposal methods were used. It is not yet clear that FFC used improper methods, but a former employee has indicated to you and the regulatory authorities that he believes this is the case. Second, the manufacturing of fireworks is inherently dangerous, with the possibility always existing that a stray spark or spontaneous combustion could result in a fire or explosion of catastrophic proportions. You believe that these risks may rise slightly if FFC proceeds with the plant installation in China.
Situational Analysis

1. Given these facts, would you recommend to the CEO that FFC proceed with a leveraged recap? Why or why not?

**Practitioner Response:** A leveraged recap could be an excellent way to effect the buy-out of the 29% interest held by the descendants of one of the founders, bring in an institutional partner that could also fund the Chinese plant investment, and perhaps even buy a small portion of the shares held by you and the CEO. FFC’s EBITDA is obviously large enough to support some debt service, and a combination of senior debt and a leveraged recap may enable FFC to accomplish many objectives simultaneously. A leveraged recap is one of the options you should recommend.

2. What options for permanent capital would you recommend for financing the new plant? Would you recommend that FFC proceed with construction before financing is in place? Why or why not?

**Practitioner Response:** If a straight mortgage or term loan secured by the plant and real estate can be obtained, these forms of financing would be least costly. If economic development funds were available from the Chinese government or from a provincial government, this type of funding may also make sense. Since FFC already has a Chinese partner who is contributing part of the cost of the plant, an exploration of additional partner financing, or from sources known to this partner, could be fruitful. Funding through the leveraged recap may be more expensive than other senior debt sources and, therefore, would likely not be the best choice. The time to complete the financing, compared to the time to build the new facility, may determine if you would recommend proceeding before permanent financing is in place. If a construction loan was unavailable, but construction was estimated to take from 9 to 12 months, FFC would presumably have more than enough time to secure permanent financing before overcommitting its line of credit.

3. If market conditions were good, but not great, would FFC be best off by trying to complete an IPO? What impact will stock ownership have on this decision? How would you recommend that the CEO deal with the inherent danger of the industry when talking to investment bankers?
Chapter 8: Post Closing Matters

Practitioner Response: An IPO might be better to examine a little later in time. Among other reasons for this are (1) market conditions might improve, (2) 2003 is expected to be a very good year, meaning that those numbers could play an important part in the offering's success at a later date, (3) a leveraged recap in the short term could eliminate the 29% overhang that would otherwise appear to exist if the IPO went forward with the one founder's descend-dants still holding their shares, and (4) the Thailand situation could be addressed and “cleaned up” before the IPO, meaning that disclosure might be very limited in this regard. Of course, market conditions could deteriorate or the corporation could find out that the Thailand plant cleanup was going to take much longer than expected, either of which may indefinitely delay the offering. The stock ownership of the founder's descendants could obviously impact the decision here, since most investment bankers would be concerned about this overhang on the public market. The inherent danger of the industry is an immutable fact that is not going to go away and, therefore, your CEO would be more effective in meetings with investment bankers by addressing this directly and simply presenting it as a fact of life in the industry. Of course, it would not hurt to state the measures that the corporation had implemented in order to reduce the risk to its lowest possible point.

4. When do you think FFC should start marketing itself to financial or strategic partners? Why at that point?

Practitioner Response: This question implies a sale of the corporation. As such, a sale late in the 2003 year would enable FFC to capitalize on the increase in value associated with the Year of the Goat and the general growth of the industry. Time may be too short to gear up for a sale based on the March 31 numbers and, if so, a decline in the next quarter's numbers could put a damper on any discussions with purchasers that were then taking place. If time is short, waiting until late in the 2003 year to present all or most of the year's improvement over the prior period might offer the best alternative. The other factor that could impact this decision would be the new Chinese plant coming on-line. Based on the reduction in manufacturing costs, FFC might be better off waiting to examine sale possibilities until the Chinese plant had been operating for two or three quarters or longer, thereby allowing the plant to “work out the kinks” and begin showing the kind of numbers that would really interest strategic or financial partners.
5. What are some of the factors that militate in favor of a private financing? A public financing?

**Practitioner Response:** A private financing would be favorable due to the time necessary to get the Chinese plant up and running, the time to secure permanent capital for the financing of the facility at a lower cost, the time required to understand and address the Thailand plant situation, and the plan to remove the overhang represented by the 29% ownership stake held by the descendants of one of the founders. An IPO would be favorable from the perspective of capitalizing on the increase caused by the Year of the Goat (if the offering could be done quickly), the creation of a liquid market into which you and the CEO could sell some of your shares, and the ever-present possibility of a fire or explosion that could have a very detrimental impact on the ability to complete an IPO at a later date.

6. What alternatives seem to be best suited to FFC maximizing its value? How does your answer change if retirement planning takes on greater importance than some of the other factors? Assuming the fireworks industry is fairly fragmented, would you consider a consolidation strategy to maximize value? Why or why not?

**Practitioner Response:** The leveraged recap or a sale to an ESOP, with its accompanying tax benefits, might be best suited to FFC, although an IPO subsequent to a leveraged recap would also appear to be quite attractive. If it assumed more importance, retirement planning would seem to argue in favor of a sale transaction with an ESOP or a strategic buyer. If the management team is willing to dedicate the time and effort to a consolidation strategy, the execution of such a strategy would no doubt build FFC's numbers and enable it to attract more capital at the time of an IPO or sale if it were successful in maintaining its margins. The question of assumed environmental liabilities could, however, taint any consolidation strategy and make it difficult, if not impossible, to complete an IPO if any of the acquired targets came with environmental issues.
APPENDIX A

SAMPLE TERM SHEET FOR PREFERRED STOCK PURCHASE BY VENTURE OR PRIVATE EQUITY INVESTOR*

COMPANY
CONFIDENTIAL TERM SHEET

Date

Company, a Delaware corporation (the "Company"), has developed a potentially revolutionary technology. The Company believes that this technology greatly improves the performance of ______________________

I. Securities Being Offered by Company (the "Company")

Minimum Number of Shares Offered: 2,000,000 Shares ($4,000,000)
Maximum Number of Shares Offered: 2,500,000 Shares ($5,000,000)
Minimum Subscription: 500,000 Shares ($1,000,000)
Price: U.S. $2.00 per Share

Use of Proceeds: Working capital

Pro Forma Ownership: Giving effect to the offering, the fully diluted ownership of the Company on an as-converted basis will be as follows:

* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
<table>
<thead>
<tr>
<th>Minimum Offering (as converted)</th>
<th>Maximum Offering (as converted)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock Outstanding</td>
<td></td>
</tr>
<tr>
<td>Preferred Stock Purchasers</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total</td>
<td></td>
</tr>
<tr>
<td>The foregoing excludes reserved and granted options.</td>
<td></td>
</tr>
</tbody>
</table>

II. Terms of the Preferred Stock

Conversion Rights: Optional Conversion: Each share of Preferred Stock is convertible at any time at the option of the holder into one share of Common Stock.

Mandatory Conversion: The Preferred Stock shall automatically convert into Common Stock upon consummation of a Qualified Public Offering, defined as an underwritten public offering of the Company’s Common Stock at an offering price equal to at least $10.00 per share and resulting in gross proceeds to the Company of at least $20,000,000.

Conversion Price: $5.00 per share, subject to standard pro rata anti-dilution adjustments for stock dividends, stock splits and similar transactions affecting the Common Stock.

Liquidation Preference: Upon any liquidation, dissolution or winding up of the Company, each holder of Preferred Stock shall be entitled to receive, prior to any distribution with respect to the Company’s Common Stock, an amount in cash equal to the greater of (i) $2.00 per share, plus any declared and unpaid dividends thereon (the “Liquidation Value”); or (ii) the amount such holder would have received in such liquidation as a holder of Common Stock on an as-converted basis.

Voting Rights: In addition to those voting rights provided by law, the Preferred Stock shall vote with the Common Stock on an as-converted basis on all matters submitted for stockholder approval. See also IV.c. hereof.

Dividend Rights: The Preferred Stock will not be entitled to a stated rate of dividends but rather will participate in all dividends paid on pari passu or junior securities on an as-converted basis.
Preemptive Rights: The holders of Preferred Stock, on a pro rata basis, will have the right to purchase any future offerings of equity securities by the Company in an amount equal to the percentage ownership of the holders in the Company calculated on an as-converted basis, subject to customary exceptions including, but not limited to, issuances to strategic partners. If any holder of Preferred Stock declines to participate in such offering (i) no anti-dilution adjustment for issuances of Common Stock at less than the Conversion Price then in effect shall be available to such declining holder with respect to such offering, and (ii) the other holders of Preferred Stock shall be entitled to purchase the declining holder’s portion of such offering.

Redemption Rights: The Company will be obligated to redeem one-third of the Preferred Stock on each of the eighth, ninth, and tenth anniversaries of the date of original issue at a redemption price equal to the then-current Liquidation Value.

Registration Rights: At any time following the Company’s initial public offering, the holders of 40% or more of the Registrable Securities (as defined below) may require the Company to register on one occasion only the Registrable Securities under the Securities Act of 1933, as amended (the “Securities Act”).

Expenses: The expenses of such registration (including the fees and expenses of one counsel to the holders of Registrable Securities but excluding underwriting discounts and commissions) shall be borne by the Company.

Registrable Securities: Common Stock issued or issuable upon conversion of the Preferred Stock, provided that any such Common Stock shall cease to be Registrable Securities following a transfer registered under the Securities Act or in an open-market transaction under Rule 144.

III. Transfer Restrictions

Right of First Refusal: Transfers of the Preferred Stock shall be subject to a right of first refusal in favor of the Company, subject to customary exceptions for transfers to affiliates or transfers for estate planning purposes.

Tag-Along Rights: The holders of Preferred Stock shall have the right to participate on a pro rata basis in any sale or transfer by any holder
of 10% or more of the Company’s Common Stock, with the exception of a Qualified Public Offering or any exercise of the Company’s repurchase right.

Drag-Along Rights:

If the holders of a majority of the outstanding voting capital stock (voting together as one class on an as-converted basis) approve a Sale of the Company (an “Approved Sale”), each stockholder shall vote for, consent to and raise no objections against such Approved Sale. “Sale of the Company” shall be defined as any transaction or series of transactions pursuant to which any person(s) or entity(ies) in the aggregate acquires (i) capital stock of the Company possessing the voting power to elect a majority of the Company’s board of directors (whether by merger, consolidation, reorganization, combination, sale or transfer of the Company’s capital stock, shareholder or voting agreement, proxy, power of attorney or otherwise), or (ii) all or substantially all of the Company’s assets determined on a consolidated basis.

IV. Covenants

Information Rights:

Board Representation: The holders of Preferred Stock shall have the right to elect one member of the Company’s board of directors. The reasonable travel expenses of such Investor Director incurred in attending board meetings shall be reimbursed by the Company.

Advisory Board: The Company shall establish an Advisory Board made up of industry experts and strategic partners. The Advisory Board shall meet at least four times per year in accordance with a schedule to be agreed upon, and the reasonable travel expenses of each member incurred in attending such meetings shall be reimbursed by the Company. Each member shall also be compensated with stock options according to a policy to be established by the Board of Directors of the Company.

Financial Information: Each holder of Preferred Stock shall be entitled to receive audited annual and unaudited quarterly financial statements. In addition, each holder of 5% or more of the outstanding Preferred Stock shall receive (i) an operating budget and updated strategic plan prior to the commencement of each fiscal year of the Company, and (ii) periodic reports on the Company’s progress with respect to milestones set forth in the strategic plan.

Inspection Rights: Each holder of 5% or more of the outstanding Preferred Stock shall have reasonable access, on a
minimum of 20 days' prior written notice, to the Company's books and records, properties and personnel.

Operational Information: Each holder of 5% or more of the outstanding Preferred Stock shall be entitled to receive a brief written monthly operational status report and to participate quarterly in a brief (not more than one hour) conference call reviewing the operational progress of the Company.

Affirmative Covenants: Customary in transactions of this type, including maintenance of corporate existence, compliance with laws, payment of taxes and other obligations, etc.

Negative Covenants: Customary in transactions of this type, including prohibition of the following without the consent of the holders of a majority of the outstanding shares of Preferred Stock:

(i) create, issue or authorize the issuance of any additional Preferred Stock or any other capital stock of the Company that is senior to or pari passu with the Preferred Stock;

(ii) amend the Company's Certificate of Incorporation or by-laws in a manner that adversely affects the holders of Preferred Stock;

(iii) issuance of incentive stock (through options, restricted stock or otherwise) in excess of 20% of the Company's fully diluted common equity; and

(iv) transactions with affiliates, not approved by a majority of the Company's disinterested directors.

V. Miscellaneous

Documentation: The purchase and sale of the Preferred Stock will be effected pursuant to definitive Purchase Agreements and related documentation containing the terms set forth herein as well as representations and warranties, closing conditions and other provisions customary in transactions of this type.

Company Management: All key employees must be engaged as full-time employees of the Company, with no other known or anticipated employment obligations.

Expenses: The Company shall reimburse all out-of-pocket expenses of the purchaser (including fees and expenses of one law firm representing the purchaser up to a maximum of $______) incurred in connection with the transactions contemplated
hereby, including negotiation of this term sheet and the definitive purchase documentation.

Sunset Provision: Upon the consummation of a Qualified Public Offering, the preemptive rights, transfer restrictions and information rights described above shall expire automatically.

SEC Compliance: At such time as the Company becomes subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the Company will use its reasonable efforts to timely file all required reports under the Exchange Act in order to enable the Investors to utilize Rule 144 in connection with transfers of the Preferred Stock (as converted). At such time as any Preferred Stock (as converted) is eligible for transfer under Rule 144(k), the Company will instruct the transfer agent to remove any restrictive legend from the certificates evidencing such capital stock upon request.

Philosophy: It is important that the management and investors of the Company share a common philosophy that the purpose of the Company is to maximize long-term shareholder (both internal and external) value. Value being defined as the appropriately discounted present value of cash the Company can generate or otherwise return to shareholders over the Company's life, whether from operations, a sale of the Company, or an IPO.

This non-binding Term Sheet is intended to facilitate the resolution of investment terms between Purchasers and the Company with respect to an equity investment by Purchasers in the Company. Due diligence by Purchasers is underway and is not yet complete. Nothing contained herein shall be binding upon either party, except and until such time that Purchasers are satisfied, in their sole discretion, with the results of due diligence, and a mutually acceptable definitive agreement is executed between the parties. However, the parties recognize their mutual obligation to negotiate and proceed in good faith toward a mutually acceptable definitive agreement to be executed by the parties.

Investment in the Shares offered hereby is highly speculative. Prospective investors should retain their own professional advisors to review and evaluate the economic, tax and other consequences of investment in a private offering and are not to construe the contents of this Term Sheet, or any other information furnished by the Company, as legal or tax advice.

PURCHASER: COMPANY:
APPENDIX B

LEVEL 3 COMMUNICATIONS, INC. SCREEN SHOTS*

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APPENDIX C

SENIOR SUBORDINATED DEBT (MEZZANINE) TERM SHEET*

ISSUER
Senior Subordinated Debt
Term Sheet

Issuer: Issuer (the “Company”)
Type of Security: Senior Subordinated Debt (“Subordinated Debt”).
Issue Size: $25 million.
Use of Proceeds: To pay down borrowings under the existing revolving credit facility, repay existing bridge loan, and to fund future working capital requirements.
Interest on Subordinated Debt: 12% per annum, payable quarterly.
Maturity of Subordinated Debt: Earlier of (i) seven years from closing or (ii) Liquidity Event (as defined below).
Warrants: Detachable warrants (“Warrants”), representing ______ shares of the common stock of the Company. The exercise price for the warrants would be equal to the average price of the common stock of the Company for the [___]-day period prior to closing.

* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
| **Maturity of Warrant:** | Earlier of (i) seven years from closing or (ii) Liquidity Event (as defined below). |
| **Liquidation Preference:** | Preference to existing common stock on liquidation. |
| **Registration Rights:** | Unlimited piggyback registration rights on registrations of the Company and other holders, subject to customary underwriter's cutback. |
| **Board Representation:** | None. |
| **Anti-Dilution Provisions:** | Protection for common stock splits, dividends and combinations only. |
| **Redemption Option:** | The Company would have the right to redeem the Subordinated Debt at par plus accrued interest at any time upon the earlier of a secondary offering or after five years from closing. |
| **Restrictive Covenants:** | The Company may not, without the consent of the Subordinated Debt, so long as at least 50% of Subordinated Debt remains outstanding, (i) effect any transaction that results in a change of control in which Subordinated Debt is not paid in full; (ii) materially change the nature of the Company's business; (iii) effect a liquidation or sale of the Company or sell all or substantially all of its assets in a transaction in which the Subordinated Debt is not paid in full; (iv) amend its articles of incorporation or bylaws in a manner that would materially and adversely affect the holder(s) of the Subordinated Debt; (v) redeem or pay any dividend or distribution on its common stock except to management upon ceasing to be employed; (vi) issue additional Subordinated Debt that is senior to Subordinated Debt; or (vii) engage in any transactions with affiliates except as otherwise contemplated by the existing documents or approved by disinterested members of the board of directors. |
| **Reporting Requirements:** | The Company shall provide the same standard financial reports that the Company provides to its senior lender(s) from time to time, so long as at least 50% of the Subordinated Debt remains outstanding. |
| **Drag-Along Rights:** | If the Board and the holders of a majority of the shares of common stock (voting as a single class) then outstanding approve a sale of the |
Company (an “Approved Sale”), each holder of Subordinated Debt and Warrants shall take all necessary or desirable actions in connection with the consummation of the Approved Sale as requested by the Board, the holders of a majority of the shares of common stock or the Company; provided that (i) upon the consummation of the Approved Sale, each holder of Subordinated Debt and Common Stock shall receive the same form and consideration and the same amount of consideration; (ii) if any holders of a class of common stock are given an option as to the form and amount of consideration to be received, each holder of such class of common stock shall be given the same option; and (iii) each holder of then currently exercisable rights to acquire shares of a class of common stock shall be given an opportunity to either (A) exercise such rights prior to the consummation of the Approved Sale and participate in such sale as holders of class of common stock or (B) upon the consummation of the Approved Sale, receive in exchange for such rights consideration equal to the amount determined by multiplying (1) the same amount of consideration per share of a class of common stock received by holders of such class of common stock in connection with the Approved Sale less the exercise price per share of such class of common stock of such rights to acquire such class of common stock by (2) the number of shares of such class of common stock represented by such rights.

Transfer Restriction: The Company will have a right of first refusal to any proposed sales, transfers, or other dispositions by the holder(s) of the Subordinated Debt.

Tag-Along Rights: Subject to certain limited exceptions (including in connection with public sales), each holder of Warrants (upon exercise of Warrants) shall be afforded the opportunity to participate in any sale of shares of common stock by selling shareholders up to its pro rata portion of the securities to be sold and on the same terms and conditions.

Pre-Emptive Rights: Until a secondary offering or an Approved Sale of the Company, each shareholder shall have the right to purchase on a pro rata basis (based upon
the number of shares of common stock held by such shareholder on a fully-diluted basis) any securities the Company may from time to time propose to issue.

Purchase Agreement:

The purchase of the Subordinated Debt and Warrants will be made pursuant to a purchase agreement, warrant, stockholders agreement and registration agreement drafted by counsel to the Company. Such agreements shall contain, among other things, appropriate representations and warranties of the Company, covenants reflecting the provisions set forth herein and other typical covenants and appropriate conditions of closing, in each case, based upon agreements currently in effect. Until the purchase agreement is signed by both the Company and the holder(s) of Subordinated Debt, there will not exist any binding obligation on the part of either party.

Expenses:

Upon consummation of the transaction as described in this term sheet, the Company will pay the expenses of the holder(s) of Subordinated Debt for legal fees of one counsel to the holder(s) of Subordinated Debt, and out-of-pocket due diligence expenses. Such fees and expenses will not exceed $25,000.
APPENDIX D

SENIOR CREDIT FACILITY
PRELIMINARY TERM SHEET*

Borrower

Borrower: 
Agent: 
Lenders: 
Purpose: To finance (i) the acquisition of __________, (ii) working capital requirements, and (iii) general corporate purposes.

Type and Amount of Senior Facility: 
Term Loan: $______ million term loan, subject to reduction as set forth below.

Revolving Credit Facility: $______ million revolving credit facility, including a sublimit for Letters of Credit, if necessary.

Closing Date: The date of the initial borrowing under the Senior Facility.

Final Drawing Date: The one-year anniversary of the Closing Date.

Final Maturity: Term Loan: Five years from the Final Drawing Date.

Revolving Credit Facility: Five years from the Closing Date.

* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
Amortization: The Term Loan will be amortized in quarterly installments beginning on the Final Drawing Date and ending on the Final Maturity Date, as follows:

<table>
<thead>
<tr>
<th>Year</th>
<th>% of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10.0%</td>
</tr>
<tr>
<td>2</td>
<td>15.0%</td>
</tr>
<tr>
<td>3</td>
<td>20.0%</td>
</tr>
<tr>
<td>4</td>
<td>25.0%</td>
</tr>
<tr>
<td>5</td>
<td>30.0%</td>
</tr>
</tbody>
</table>

Revolving Credit Facility: The Revolving Credit loans shall be paid in full at maturity.

Availability: A single drawing of up to $_______ million (the “Initial Term Amount”) may be made at the Closing Date to finance the acquisition of _______________ and to pay related fees and expenses. The amount of Term Loan unutilized on the Closing Date (the “Escrowed Term Amount”) shall be funded in escrow. The Borrower shall have the ability to draw upon the Escrowed Term Amount on the Closing Date and periodically thereafter up to but excluding the Final Drawing Date, provided that the Borrower has met certain thresholds (to be determined) pertaining to its financial performance. Further, it is contemplated that funding of the Escrowed Term Amount may be allowed pursuant to either a secondary offering of common stock or the call of certain issued and outstanding warrants. Lenders’ commitments under the Term Loan shall automatically be reduced on the Final Drawing Date by the unutilized portion of Escrowed Term Amount on such date.

Revolving Credit Facility: Assuming full utilization of the Term Loans and subject to availability under the Borrowing Base, a drawing of up to $_______ million may be made on the Closing Date to finance working capital and to pay related fees and expenses, and additional drawings may be made at any time from the Closing Date to, but excluding, the Final Maturity of the Revolving Credit Facility for working capital and general corporate purposes.

Borrowing Base: The sum of ___% of Eligible Accounts Receivable (to be defined) and ___% of Eligible Inventory (to be defined).

Interest: At the Borrower’s option, Base Rate and LIBOR loans will be available as follows:
Base Rate Option: Interest shall be at the Base Rate of the Agent plus the appropriate interest margin, calculated on the basis of the actual number of days elapsed in a year of 365 days, payable quarterly in arrears. The Base Rate is defined as the higher of the Federal Funds Rate as published by the Federal Reserve Bank of New York plus 1/2 of 1%, or the prime commercial lending rate of the Agent as announced from time to time at its head office. Base Rate drawings shall be made available on a same-day basis if requested prior to 10:00 a.m. New York time and shall be in minimum amounts of $_________ and incremental multiples of $_________.

LIBOR Option: Interest shall be determined for periods ("Interest Periods") of one, two, three or six months (as selected by the Borrower) and shall be at an annual rate equal to the London Interbank Offered Rate ("LIBOR") for the corresponding deposits of U.S. Dollars plus the appropriate interest margin. LIBOR will be determined by the Reference Lenders at the beginning of each Interest Period. Interest will be paid at the end of each Interest Period or quarterly, whichever is earlier, and will be calculated on the basis of a 360-day year and actual number of days elapsed. LIBOR drawings shall require three business days’ prior notice and shall be in minimum amounts of $_________ and incremental multiples of $_________.

Interest Margin: The applicable interest margins shall be as follows:

<table>
<thead>
<tr>
<th>Base Rate Loans</th>
<th>LIBOR Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Term Loan</td>
<td>2.00%</td>
</tr>
<tr>
<td>Revolving Credit Loans</td>
<td>1.50%</td>
</tr>
</tbody>
</table>

Default Interest: ___% per annum in excess of the rate otherwise applicable upon the occurrence and during the continuance of any payment default and after the lapse of any applicable grace periods, payable upon demand.

Commitment Fees: Commitment Fees of 1/2 of 1% per annum on the unused commitments under the Senior Facility shall be payable to the Agent, for the account of the Lenders, from and after the Closing Date. Accrued commitment fees will be payable quarterly in arrears (calculated on a 360-day year basis).

Mandatory Payments: 100% of the net proceeds (to be defined) received from (i) the sale or disposition of all or any part of the assets of the
Borrower or any of its subsidiaries (other than sales of inventory in the ordinary course of business), (ii) the incurrence of any indebtedness for borrowed money or the issuance of debt or equity Securities by the Borrower after the Closing Date, (iii) at the Agent’s discretion, insurance recoveries other than recoveries of less than a threshold amount to be determined that are promptly applied toward repair or replacement of the damaged property. In addition, whether 90 days after the end of each fiscal year of the Borrower, a mandatory prepayment equal to 75% of Excess Cash Flow (to be defined) for such fiscal year shall be required. Mandatory prepayments shall be applied without penalty or premium (except for LIBOR breakage costs, if any) to Term Loan installments in inverse order of maturity, and thereafter to reduce outstanding loans under the Revolving Credit Facility.

Voluntary Prepayments: Permitted in whole or in part with prior notice but without premium or penalty, subject to minimum prepayments of $____ or integral multiples of $______ in excess of $_______. LIBOR loans may only be prepaid on the last day of the applicable Interest Period. Voluntary prepayments shall be applied without penalty or premium (except for LIBOR breakage costs, if any) to Term Loan installments in inverse order of maturity, and thereafter to reduce outstanding loans under the Revolving Credit Facility.

Security: The Senior Facility will be secured by perfected first priority security interest in favor of the Lenders in all accounts receivable, inventory, property, plant and equipment, intangibles, contract rights and other personal, intellectual and real property of the Borrower and its subsidiaries, if any.

Conditions Precedent: Conditions precedent to the initial borrowing under the Senior Facility will include those customary for the Agent and which are appropriate to this transaction.

Covenants: Covenants for the Senior Facility will include those customary for the Agent and which are appropriate to this transaction.

Events of Default: Will include those customary for the Agent and which are appropriate to this transaction.

Fees and Expenses: Borrower is responsible for all reasonable counsel’s fees and expenses regardless of whether a definitive loan agreement is executed or the transaction is closed, as well as expenses for collateral audits.
**Indemnification:** As provided in Exhibit A hereto.

**Assignments and Participations:** Each Lender may assign all or a portion of its loans and commitments under the Senior Facility (which shall not have to be pro rata among the Senior Facility) or sell participation therein to another person or persons subject to limitation, if any, established by the Agent.

**Governing Law:** The law of the State of ____________.
APPENDIX E

IPO LETTER OF INTENT*

Date
Company
Address
Re: Letter of Intent
Dear __________:

Discussions have taken place during the past several weeks between the representatives of the undersigned and Company (the “Company”) regarding a proposed public offering (“Public Offering”) of securities of the Company. Based upon such discussions, the Company and the undersigned have agreed to enter into this letter of intent.

In the course of such discussions, you have provided or will provide the undersigned with certain information regarding the Company, including but not limited to, recent unaudited financial statements which you and the Company represent as fairly reflecting the financial condition of the Company and the results of its operations for the periods mentioned therein, and financial projections as prepared by the Company’s management, and various industry and other information.

After review of the material submitted, your representations, and other investigations, the undersigned is pleased to submit for your approval a program for the financing of the Company by means of a Public Offering. The Public Offering will be arranged by the undersigned as the managing underwriter on a “firm commitment” basis in accordance with the terms and conditions set forth below.

1. Public Offering. Underwriter would be willing to act as the representative of the underwriters (the “Representative”), acting on a firm commitment

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basis, and as managing underwriter in the Public Offering by the Company of 1,000,000 shares of common stock ("Shares") at an offering price to be determined by the Company and the Representative immediately prior to the date a registration statement with respect to the Shares is declared effective by the Securities and Exchange Commission (the "Effective Date"). The Company and the Representative expect that the offering will be priced between $8.00 and $9.00 per share, but in no event to be more than $9.00 per share.

2. **Over-Allotment Option.** In order to cover over-allotments, if any, the Company shall grant the Representative an option to purchase from it all or part of an additional number of Shares equal to 15% of the number of Shares sold in the underwriting (the "Over-Allotment Shares") at a price per Share equal to the price per Share to be paid by the Representative for the Shares. The option shall be exercisable, in whole or in part, from time to time during the 45 day period commencing with the Effective Date, at the sole discretion of the Representative.

3. **Syndicate Formation.** In connection with the Public Offering, we shall have the right to form a syndicate of co-underwriters and selected dealers who will assist us in the Public Offering. Any firm with whom we associate will be a member in good standing of the National Association of Securities Dealers, Inc. ("NASD"). The Representative shall have the sole right to determine whether one or more co-underwriters shall assist in underwriting the Public Offering and the identity of such co-underwriter or co-underwriters, although the Company may assist in the identification of such potential co-underwriters.

4. **Registration Statement.**

a. The Company shall file with the Securities and Exchange Commission (the "Commission"), a registration statement on Form S-1, or, as the case may be, Form SB-2, (the "Registration Statement") in conformity with the Securities Act of 1933, as amended (the "1933 Act"), covering the Public Offering of the Shares and the Over-Allotment Shares. Further, the Registration Statement shall cover a sufficient number of Representative's Warrants (defined below) which may be issued by the Company to us or our assigns.

b. Neither the offer nor sale of the Shares or the Over-Allotment Shares pursuant to the Registration Statement nor any of the Representative's Warrants shall be subject to any preemptive right, however characterized or described. It is our understanding and agreement with the Company that prior to the filing of the Registration Statement, the Company will have an authorized capitalization of approximately 100,000,000 shares of Common Stock and approximately 15,000,000 shares of Preferred Stock. Approximately 5,000,000 shares of Common Stock will be outstanding and approximately $500,000 in liquidation value of Redeemable Convertible Preferred Stock will be outstanding. Notwithstanding anything contained herein to the contrary, in the prospectus portion of the Registration Statement ("Prospectus") there may be disclosed an equity incentive stock option plan covering approximately 500,000 shares. No other securities other than the outstanding preferred stock described above or that is issued in conjunction with acquisitions or that are exercisable for
or convertible into shares of the Company’s common stock shall be outstanding prior to the Effective Date.

c. After approval by us and our counsel of the final draft of the Registration Statement, the Company shall file the Registration Statement with the Commission as soon as practicable. The Registration Statement shall include appropriate consolidated financial statements audited by an independent certified public accountant, which accountant shall give an opinion in the final Registration Statement, and which accountant shall issue appropriate “cold comfort” letters on the Effective Date and the closing date of the Public Offering (“Closing Date”) to within three business days of such dates. Thereafter, the Company shall utilize its best efforts and due diligence to cause the Registration Statement to be declared effective by the Commission so that the Public Offering may commence; provided, however, effectiveness shall not be allowed to occur without our prior written consent. The proceeds to be realized by the Company shall be used as set forth in the Registration Statement and shall not be used to repay debt to officers, directors, stockholders, derivative security holders or affiliates of the Company without the Representative’s written consent.

5. Authorized Capital. The Company shall represent and warrant to us, in an Underwriting Agreement to be furnished by us in customary form and content, that the Company has sufficient authorized securities to be offered and sold as contemplated hereby, and to provide for the Representative’s Warrants and the securities underlying such Representative’s Warrants.

6. Representative’s Share Purchase Warrants. At the Closing of the Public Offering, the Company will sell to the Representative for a total purchase price of $100, warrants (the “Representative’s Warrants”) entitling the Representative or its assigns to purchase one share of the Company’s common stock for each 10 Shares sold in the Public Offering (excluding the Over-Allotment Shares). The Representative’s Warrants shall be exercisable commencing one year from the Effective Date and shall expire five years from the Effective Date. The Representative’s Warrants will contain the maximum anti-dilution provisions as permitted by the NASD and may provide for the cashless exercise of such Representative’s Warrants utilizing securities of the Company (which may include the implicit value of the Representative’s Warrants being surrendered). The exercise price of the Representative’s Warrants shall be an amount equal to 120% of the offering price of the Shares sold in the Public Offering. The Company shall set aside and at all times have available a sufficient number of securities to be issued upon exercise of the Representative’s Warrants. The Representative’s Warrants and underlying securities will not be transferable to anyone for a period of one year after the Effective Date of the Company’s Registration Statement, except to officers of the Representative, co-underwriters, selling group members and their officers or partners. Thereafter, the Representative’s Warrants and underlying securities will be transferable provided such transfer is in accordance with the provisions of the 1933 Act.

The Company will agree that, upon written request of the then holder(s) of at least a majority of the Representative’s Warrants and the securities underlying
the Representative’s Warrants which were originally issued to the Representative or to its assigns, made at any time within the period commencing one year from the Effective Date and ending five years after the Effective Date, the Company will file, at its sole expense, no more than once, a registration statement or post-effective amendment under the 1933 Act registering the securities underlying the Representative’s Warrants. The Company agrees to use its best efforts to cause the registration statement or post-effective amendment to become effective. The holders of the Representative’s Warrants may demand registration without exercising the Representative’s Warrants and, in fact, are never required to exercise same. The Registration Statement will include the securities underlying the Representative’s Warrants.

The Company understands and will agree that if, at any time within the period commencing on the Effective Date and ending seven years after the Effective Date, it should file a registration statement with the Commission pursuant to the 1933 Act, regardless of whether some of the holders of the Representative’s Warrants and underlying securities shall have theretofore availed themselves of the right above provided, the Company, at its own expense, will offer on two occasions to said holders the opportunity to register the securities underlying the Representative’s Warrants. This paragraph is not applicable to a registration statement filed by the Company with the Commission on Form S-8 or any other inappropriate form of registration statement or offering statement.

In addition to the rights above provided, the Company will cooperate with the then holders of the Representative’s Warrants and underlying securities in preparing and signing a registration statement, on two occasions only, in addition to the registration statements discussed above, required in order to sell or transfer the securities underlying the Representative’s Warrants and will supply all information required therefor, but such additional registration statements shall be at the then holders’ cost and expense unless the Company elects to register additional shares of the Company’s Common Stock in which case the cost and expense of such registration statements will be prorated between the Company and the holders of the Representative’s Warrants and underlying securities according to the aggregate sales prices of the securities being issued.

7. Additional Commission Filings. Prior to the Effective Date, the Company shall have properly and timely filed with the Commission a registration statement on Form 8-A to register its securities under the Securities Exchange Act of 1934, as amended (the “1934 Act”). The Company shall for a period of five years after the Effective Date promptly furnish us with copies of all material filed with the Commission pursuant to the 1934 Act or otherwise furnished to stockholders of the Company.

8. Nasdaq Listing. The Company shall at its cost and expense take all necessary and appropriate action so that the Shares, to the extent eligible, are listed for trading on the Nasdaq National Market or, as the case may be, the Nasdaq SmallCap Market, on the Effective Date and that the securities remain listed for at least 10 years thereafter provided that the Company otherwise complies with the prevailing requirements of Nasdaq. In addition, if at the time of the
Public Offering the Shares are not eligible for listing on the Nasdaq National Market, the Company shall, at such time as the Company qualifies for listing its securities on the Nasdaq National Market, take all steps necessary to have the Shares listed on the Nasdaq National Market.

9. **Report Listing.** The Company shall, on or about the Effective Date, apply for listing in Standard and Poor's Corporation Records and shall use its best efforts to have the Company listed in such reports for a period of not less than 10 years from the Closing Date. The Company will request accelerated treatment in the Daily News Supplement of Standard and Poor's Corporation Records.

10. **Due Diligence.**

a. The Company shall supply and deliver to us and our counsel at their respective offices, all information reasonably required to enable us to make such investigation of the Company and its business prospects as we or our counsel shall desire and shall make available to us at our offices such person(s) as we shall deem reasonably necessary and appropriate in order to verify or substantiate any such information supplied. We shall have the right to review any materials prepared in connection with the offering of securities of the Company conducted prior to the Public Offering for compliance with applicable federal and state securities laws.

b. For a period of five years after the Closing, the Company shall furnish unaudited quarterly financial statements including both a balance sheet and statement of income to us on a timely basis in addition to any other reports which may be issued. The Company shall cause its Board of Directors to meet, at least quarterly, upon proper notice. The Representative shall receive notice of any regular or special meetings of the Company’s Board of Directors concurrently with the sending of such notice to the Company’s directors and shall have the right to have a representative attend such meeting as an observer, as described below.

11. **Blue Sky and Other Costs.** The Company shall be responsible for and shall bear all expenses directly and necessarily incurred in connection with the proposed financing, including: (i) the preparation, printing and filing of the offering documents and amendments thereto, including the Commission, NASD, Nasdaq filing and/or application fees, preliminary and final Prospectuses and the printing of the underwriting agreement, the agreement among underwriters and the selected dealers’ agreement, preliminary and final “Blue Sky” memorandums, material to be circulated to the Underwriters by us and other incidental material; (ii) the issuance and delivery of certificates representing the Shares, including original issue and transfer taxes, if any; (iii) the qualifications of the Shares under state securities or Blue Sky laws, including reasonable fees of counsel to the Representative, who shall be retained by the Company at its expense to prepare and file all such qualifications and who shall prepare a preliminary and final blue sky survey; (iv) the fees and disbursements of counsel for the Company and the accountants for the Company; and (v) any other costs of qualifying the Shares, to the extent eligible, for listing on the Nasdaq SmallCap Market or the Nasdaq National Market.
12. **Signing of Underwriting Agreement.** Within 24 hours of the Effective Date of the Registration Statement, we shall enter into an underwriting agreement with the Company ("Underwriting Agreement"), which Underwriting Agreement shall by its terms become effective on the Effective Date and shall contain terms and conditions usually and customarily found in instruments of like nature and containing among other things, the usual market out conditions, calamity clauses and cross-indemnity provisions against liabilities, including liabilities under the 1933 Act. A form of such Underwriting Agreement shall be furnished to the Company by us. In addition, the Underwriting Agreement shall provide that the Closing of the proposed Public Offering shall occur on the third business day subsequent to the Effective Date, unless the Registration Statement is declared effective by the Commission after 4:30 p.m. Eastern time, in which event the Underwriting Agreement shall provide that the Closing of the Public Offering shall occur on the fourth business day after the Effective Date. The Company shall utilize its best efforts to obtain an effective date for the Registration Statement, as amended, on or before __________.

13. **Underwriting Compensation.**

a. The Underwriting Agreement shall provide that the several Underwriters shall be entitled to an underwriting discount of 10% (or such lesser discount as shall be approved by the NASD) from the total Public Offering price, such that the Underwriters may purchase the Shares and Over-Allotment Shares, if any, from the Company at 10% less (or such lesser discount as shall be approved by the NASD) than the Public Offering price fixed by the final Prospectus.

b. The Underwriting Agreement shall provide that upon the successful completion of the Public Offering we, as Representative, shall be reimbursed on a non-accountable basis for our expenses in a sum equal to 3% of the total Public Offering price of the Shares (including the Over-Allotment Shares). The Company agrees to deliver to the Representative, upon execution of this letter of intent and contemporaneously with the filing of the Registration Statement, advances of $______ each, to be considered advances upon the non-accountable expense allowance. The Representative shall return to the Company any unaccounted portion of the amounts advanced to it in the event the offering is not consummated. Likewise, if the Public Offering is not consummated, the Representative will be reimbursed only for its actual accountable out of pocket expenses. Any expense incurred by the Representative shall be deemed to be reasonable and unobjectionable upon a reasonable showing by the Representative that such expenses were incurred, directly or indirectly, in connection with the proposed and/or relationship of the parties hereto, as described herein.

c. If, after executing this letter of intent and prior to the execution of the Underwriting Agreement, the Company elects not to expeditiously proceed with the Public Offering even though the Representative is ready, willing and able to proceed with the Public Offering within the price range set forth herein, then the Company agrees that it will not sell any of its capital stock to the public through another underwriter for a period of at least 12 months from the date hereof. If after executing this letter of intent and prior to consummation of the Public
Offering, the Company is acquired, merges, sells all or substantially all of its assets or otherwise effects a corporate reorganization with any other entity and, as a result, the Public Offering is abandoned by the Company, then the Company shall pay the Representative a financial advisory fee of $_______ which the Company and the Representative agree is fair compensation to the Representative. The Representative shall act as the Company’s investment banker in connection with any such acquisition and render such services as are customary in connection therewith in consideration for this fee. Any fee payable with respect to a fairness opinion shall be in addition to the advisory fee discussed above.

d. If the Public Offering is not consummated, the Representative shall return to the Company such portion of the amounts advanced to it pursuant to paragraph 13(b) above that is not accounted for by the Representative, so that the Representative will be reimbursed only for its actual accountable out-of-pocket expenses, including its legal fees and disbursements, calculated as provided in paragraph 13(b) above.

e. If the Public Offering is not consummated because the Representative determines, in its sole judgment, that market conditions are unsuitable for such an offering or if information comes to the Representative's attention relating to the Company, its management or its position in the industry that could, in the Representative's sole judgment, preclude a successful offering of the Shares to the public, then the maximum amount to which the Representative shall be entitled shall be the reimbursement of its out-of-pocket expenses which shall be deducted from the advances against the non accountable expense allowance. If the Company elects not to expeditiously proceed with the Public Offering for reasons other than that set forth in paragraph 13(c) above, or if the conditions, representations, warranties and covenants of the Company are not materially correct and cannot be complied with, then the Company shall (1) reimburse the Representative in full for its out-of-pocket expenses including its legal fees and disbursements, but not to exceed an aggregate of $_______ in excess of the advances paid by the Company to the Representative pursuant to paragraph 13(b) hereof, (2) pay all Blue Sky filing fees and expenses, including Blue Sky legal fees of the Representative’s counsel retained by the Company for such purpose, and (3) indemnify and hold harmless the Representative for any expenses incurred by the Company in connection with the Public Offering including, but not limited to, printing expenses and the Company’s accounting and legal fees.

14. Other Agreements.

a. The Representative shall have the right to designate an observer to meetings of the Company’s Board of Directors, which right shall begin at the Effective Date and survive for a period of five years from the Effective Date. If designated, such observer shall attend meetings of the Board of Directors and receive reimbursement for all reasonable costs and expenses incurred in attending such meetings, including but not limited to, food, lodging and transportation, together with such other cash fee or other cash compensation as is paid by the Company to members of the Board of Directors (but excluding options or other non-cash consideration). Moreover, to the extent permitted by law, the Company
will agree to indemnify the Representative and its observer in relation to the observer’s activities as observer. In the event the Company maintains a liability insurance policy affording coverage for the acts of its officers and/or directors, it will agree, to the extent permitted under such policy, to include each of the Representative and its observer as an insured under such policy. The observer, whether the Representative or its designee, shall receive cash compensation equal to the highest cash compensation received by any independent member of the Board of Directors of the Company.

b. The Company shall engage the services of a reputable public relations firm that is reasonably acceptable to the Representative, as of the Effective Date and for a minimum period of 12 months thereafter, for the purpose of facilitating appropriate dissemination of information by the Company to its stockholders, the media and the public securities markets.

c. The Company shall use a financial printer acceptable to the underwriter.

15. **Conflict of Law.** If any provision of this letter of intent conflicts with any rule or regulation under the 1933 Act, or the state securities Blue Sky laws or the jurisdictions in which the Public Offering is to be qualified, the NASD, Nasdaq, or any other state or federal authority possessing jurisdiction over the Public Offering, the Company shall meet with us and together we shall use our best efforts in good faith to review the terms of the Public Offering so as to comply with any such rule or regulation.

16. **Restriction on Securities.**

a. All officers, directors and stockholders of the Company prior to the Effective Date (including holders of derivative securities) shall agree not to sell, transfer, pledge or convey any capital stock or securities that are issuable upon exercise or conversion of the derivative securities, by registration or otherwise, for a period of nine months from the Effective Date without the prior written consent of the Representative (which consent will not be unreasonably withheld), or for any greater period required by any state in which the offering of the Shares is to be registered; except that, subject to compliance with applicable securities laws, any such officer, director or stockholder may transfer his or her stock in a private transaction, provided that any such transferee shall agree, as a condition to such transfer, to be bound by the restrictions set forth herein and further provided that the transferor, except in the case of the transferor’s death, shall continue to be deemed the beneficial owner of such Shares in accordance with Regulation 13d-(3) of the 1934 Act. The Company shall also cause its officers, directors and employees that may rely on Rule 701 to make sales of common stock after completion of the Public Offering to enter into lock-up agreements for a period of nine months. Such officers, directors and stockholders shall agree to enter into a lock up agreement in standard form, to the placing of a related restrictive legend on the certificates representing their shares and to the Representative holding such securities in an account designated by the Representative. The nine month lock-up shall also apply to the registration of shares underlying stock options using Form S-8.
b. The Company and all officers, directors and holders of five percent or more of the Common Stock of the Company will further agree not to sell, transfer, hypothecate or convey any capital stock or derivative securities of the Company through a "Regulation S" transaction for a minimum period of three years from the Effective Date without the prior written consent of the Representative. In addition, the Company will agree not to sell, transfer, hypothecate or convey any capital stock or derivative securities of the Company for a minimum period of 12 months from the Effective Date without the prior written consent of the Representative which consent will not be withheld unreasonably, except the Company may issue its common stock on the exercise of stock options and may issue common stock or preferred stock for use in acquisitions.

17. Finders. The Company and we represent that no person has acted as a finder in connection with the transactions contemplated herein and each will agree to indemnify the other with respect to any claim or finder's fee in connection with the Public Offering.

18. Further Representations of the Company.

a. The Company shall employ the services of an auditing firm acceptable to the Representative in connection with the preparation of the financial statements required to be included in the Registration Statement and shall continue to appoint such auditors or such other auditors as are reasonably acceptable to the Representative for a period of five years following the Effective Date of the Registration Statement.

b. Prior to the Effective Date, the Company will enter into employment agreements with its key management employees with the terms thereof including the term and the compensation of each person subject to the reasonable approval of the Representative. The compensation payable to such persons shall be acceptable to the Representative so long as such compensation is within industry standards.

c. The Company shall bear the cost of preparing and delivering to the Representative and its counsel four leather bound volumes containing copies of all documents and appropriate correspondence filed with or received from the Commission, Nasdaq and the NASD, and all closing documents.

d. The Company will for a period of five years:

(i) Furnish to the Representative and to the Company's stockholders annual audited financial statements.

(ii) Distribute an annual report meeting the requirements of Rule 14a-3 under the 1934 Act to all stockholders setting forth clearly the financial position of the Company.

(iii) Designate an Audit Committee and a Compensation Committee (the members of which shall be subject to our reasonable approval) which will generally supervise the financial affairs and executive compensation of the Company, respectively. The Audit Committee shall be comprised of members
that meet the listing standards of the Nasdaq Stock Market, Inc. and will comply with its obligations as outlined in 1934 Act Release No. 34-42266.

(iv) At its expense, shall cause its regularly engaged independent certified public accountants to review (but not audit) the Company’s financial statements for each of the first three fiscal quarters prior to the announcement of quarterly financial information, the filing of the Company’s quarterly reports and the mailing of quarterly financial information to security holders, all in accordance with the obligations imposed upon such accountants by 1934 Act Release No. 34-42266.

e. The Company will cause its transfer agent to furnish to the Representative a duplicate copy of the daily transfer sheets prepared by the transfer agent during the six-month period commencing on the Effective Date and, for a period of four and one-half years thereafter, the Representative shall have the right to request duplicate copies of such transfer sheets and/or a duplicate copy of a list of stockholders, in its sole discretion and at the Company’s expense.

f. Our obligation under the underwriting agreement shall be subject to, among other things, there being, in our opinion: (i) no material adverse change in the conditions or obligations of the Company or its present or proposed business and affairs; or (ii) no market conditions which might render the offer and sale of the Shares herein contemplated inadvisable. Further, our obligations shall be subject to the Company’s successful listing of its securities on the Nasdaq SmallCap Market or the Nasdaq National Market.

g. This letter is not, and your acceptance hereof does not, constitute a prior agreement to consummate the financing outlined above. Such binding agreement shall be contained only in the Underwriting Agreement or an agreement to enter into an Underwriting Agreement.

h. The Company agrees that in the event the Committee on Corporate Financing of the NASD shall determine that any Company stock or stock options issued to, or financial consulting or other agreements of the Company, with any person or persons who are unaffiliated with the Representative are nevertheless considered underwriting compensation, the Company will take such action as the NASD may require to prevent such stock options or agreements from having any adverse effect on the Representative’s allowable compensation. In the event that the NASD still deems the Representative’s compensation to be unacceptable, the Representative shall, in its sole discretion, make such further adjustments to the form of its compensation as it deems necessary to obtain NASD clearance, so long as such compensation adjustments do not increase the amount of total compensation provided for in this letter of intent.

i. Certificates for the securities offered shall be first submitted to the Representative for approval prior to printing. The Company shall, as promptly as possible after filing the Registration Statement with the Commission, have the Shares eligible for closing through Depository Trust Company.
19. **Aftermarket Support.** As a matter of policy, the Representative sponsors its underwriting clients with aftermarket activities to ensure that its customers, other members of the investing public, and the various segments of the financial community will be kept abreast of developments relating to the Company and its industry. The Representative intends to make a market in the Company’s securities after the Public Offering, and will use its best efforts to interest other investment banking firms and research analysts in following the Company. The Company shall assist the Representative in its aftermarket support activities by being available to hold periodic updates with the Representative, market makers, analysts and their representatives.

20. **Performance Escrow.** The majority shareholder of the Company’s common stock outstanding prior to the Public Offering will place in an escrow account an aggregate of 600,000 shares of common stock at or prior to the Effective Date. Such shares of common stock shall be subject to release from escrow upon: (i) the Company achieving revenues exceeding $100.0 million and EBITDA exceeding $10.0 million in fiscal year 2002; or (ii) the Company achieving revenues exceeding $250.0 million and EBITDA exceeding $25.0 million in fiscal year 2003. In the event the Company fails to meet the criteria set forth above in fiscal 2002 or fiscal 2003, the escrowed shares of Common Stock shall be released at the earlier of: (i) seven years from the Effective Date, or (ii) consummation of a merger, acquisition or exchange in which the Company is not the surviving entity or in which the majority shareholder of the Company owns less than 50% of the outstanding capital stock of the surviving entity following such transactions or the sale of all or substantially all of the assets of the Company that is approved by a majority of the holders of the outstanding shares, excluding the shares held in the escrow account.

21. **Letter of Intent.**

a. Notwithstanding anything contained herein to the contrary, it is expressly understood that this document is a letter of intent and that no liability or obligation of any nature whatsoever is intended to be created between any of the parties hereto, except for the liability for expenses provided for in Paragraphs 11 and 13. This letter does not and is not intended to constitute a binding agreement to consummate the Public Offering outlined herein, nor an agreement to enter into the Underwriting Agreement. The parties propose to proceed promptly and in good faith to conclude arrangements with respect to the proposed Public Offering and any legal obligations between the parties shall be only as set forth in the Underwriting Agreement.

b. This letter of intent shall be construed under the Laws of the State of __________. The Representative and the Company agree that any controversy arising out of or relating to this letter of intent or proposed Public Offering shall be arbitrated under binding arbitration in __________ in accordance with the rules then in effect of the NASD.

This letter of intent may be signed in counterparts, but all such counterpart signatures shall be considered as a single document.
c. If a party signs this letter of intent and transmits an electronic facsimile of the signature page to the other party, the party who receives the facsimile transmission may rely upon the electronic facsimile as a signed original of this letter of intent. By acceptance hereof, the Company agrees not to "shop" this letter of intent with other investment bankers. This letter of intent shall be effective only if executed by the parties on or prior to the close of business on ________.

If the foregoing is agreeable to you, kindly execute a duplicate copy of this letter of intent and deliver it to the undersigned at the address set forth on the first page hereof

UNDERWRITER
By: ________________________________

The terms of this letter of intent have been accepted and agreed to as of the date first above written.

COMPANY
By: ________________________________
Date
Company
Address
Gentlemen:

This is to record the mutual intention of Company (the “Company”) and Underwriters (the “Underwriters”) to undertake a public offering of 2.6 million shares of Common Stock (the “Common Stock”).

1. Subject to the satisfactory completion of our normal due diligence analysis, market conditions at the time of such offering and execution and delivery of the definitive underwriting agreement referred to below, it is our intention to purchase 2.6 million shares of Common Stock from the Company and to resell such securities to the public in an offering (the “Offering”) to be registered with the Securities and Exchange Commission (the “SEC”) on Form SB-1 under the Securities Act of 1933. The Company will also grant the Underwriters a 30 day over-allotment option to purchase up to an additional 390,000 shares of the Common Stock.

2. In consideration of our effort to market the Common Stock, the Company will proceed to prepare and to file a registration statement with the SEC. The registration statement, all amendments thereto and all related filings with the SEC shall be subject to approval by us and our counsel before the filing is made.

*This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
3. The Company will pay all expenses normally related to an underwriting, including, but not limited to, the fees and expenses of its counsel, printing, accounting, postage, SEC and NASD filing fees, state fees and the portion of the fees and expenses of our counsel which relate to the obtaining of Blue Sky qualifications in various states. In addition, the Company will pay all out-of-pocket travel expenses of its officers relating to the roadshow. The Underwriters will pay for the expenses, including meeting room, food and beverage charges, of holding information meetings with respect to the Offering for institutional and retail investors. In addition, the Underwriters will be responsible for their own expenses (including the fees and the expenses of their counsel) and will pay the expenses of running the customary advertisements in various publications following the Offering. Notwithstanding the foregoing, the Company shall reimburse the Underwriters on demand for all their out-of-pocket expenses, including, without limitation, the fees and disbursements of their counsel, in the event that the Underwriters discover during due diligence an issue concerning the Company or its business, financial condition, results of operations or prospects which the Underwriters reasonably determine could have a material adverse effect on the marketing of the Offering and end their involvement in the Offering, or if the Company, for whatever reason, decides not to pursue, abandons or otherwise fails to proceed with the Offering or decides to terminate the involvement of the Underwriters in the offering.

4. The exact terms of the underwriting will be set forth in an underwriting agreement to be entered into by the Underwriters and the Company. The public offering price per share of the Common Stock will be determined immediately prior to commencement of the Offering, and such price shall be agreed to by the Underwriters and the Company after full consideration of market conditions existing at that time. The underwriting spread is expected to be 7.0% of the public offering price and will be determined at the time of final pricing. The underwriting agreement between us will contain customary reciprocal indemnification provisions.

5. The Underwriters will not be bound to receive and pay for, and the Company will not be bound to issue and sell, the Common Stock until Blue Sky qualifications have been assured in a reasonable number of states to our mutual satisfaction, and a final underwriting agreement satisfactory to each of us is executed.

6. This letter of intent is submitted by us as a statement of mutual intention and creates no binding obligation of any kind on the Company or us other than as set forth in the last sentence of the fourth paragraph of this letter. The document which defines the formal commitment is the underwriting agreement which, subject to the conditions described herein, would be created by the Company and the Underwriters immediately prior to the commencement of the Offering. We look forward to working with you and your associates on the proposed Offering.
If the foregoing is in accordance with your understanding of the intentions of the parties, please note your approval on this letter and return it to us.

Sincerely,

UNDERWRITERS

By: ______________________

Its: ______________________

AGREED:

This ____ day of ______, 2002.

COMPANY

By: ______________________

Its: ______________________
APPENDIX G

INVESTMENT BANKING ENGAGEMENT AGREEMENT FOR INSTITUTIONAL PLACEMENT*

Date
Company
Address
Gentlemen:

This letter will confirm the terms and conditions of the engagement of the Advisor (the "Advisor"), by Company (the "Company") to act as the exclusive financial advisor to the Company in connection with the exploration of one or more private equity or debt offerings ("Financing Transactions"). The Advisor's services in connection with the Financing Transactions are hereinafter referred to as the "Engagement." The decision to complete a Financing Transaction will be at the sole discretion of the Company.

1. As the Company's exclusive financial advisor, the Advisor will immediately assist the Company, on a best efforts basis, in completing a private debt or equity offering, the success and completion of each of which would be subject to, among other things, the performance of the Company. The Advisor shall provide financial advisory services, including, but not limited to, the following:

   (a) assisting the Company and/or its consultants in developing a financial model based upon management’s operating assumptions that will incorporate various capital structures and market assumptions to allow management to understand the potential impact of its various financing strategies;

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*This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
Appendix G: Investment Banking Engagement Agreement

(b) assisting the Company and its board of directors in developing and executing a financing strategy;

(c) assisting the Company in its presentations to potential lenders and purchasers of the Company’s securities;

(d) assisting the Company in executing the Financing Transactions; and

(e) advising the Company’s management and board of directors on matters related to the Financing Transactions.

2. In performing its services hereunder, the Advisor shall familiarize itself with and consider, among other things, the history and nature of the business of the Company, the condition and prospectus of the Company’s industry, the operations, financial results, conditions, properties and prospects of the Company, and such other factors as the Advisor deems relevant. The Advisor shall be entitled to rely entirely, without independent investigation, on publicly available information and such other information as may be supplied by the Company. The Company shall be solely responsible for the legal sufficiency, accuracy and completeness of any information memorandum or other disclosure document as well as for the Company’s compliance with all applicable laws and regulations relating to the Financing Transactions. For the sake of clarity, the scope of our engagement shall not include giving tax, legal, regulatory, accountancy or other specialist or technical advice from other sources.

3. The Company acknowledges that the availability of the Advisor to perform its services is in large part dependent on the Company furnishing the Advisor with information regarding the Company in a timely fashion. The Company agrees to promptly furnish the Advisor with all financial and other information regarding the Company and its business and financial prospects, insofar as such information is available to it, that the Advisor may reasonably request, and to provide to the Advisor reasonable access to the Company’s officers, directors, employees, accountants, legal counsel and other advisors.

4. The Company hereby represents and warrants that all information furnished to the Advisor by the Company shall be complete and correct in all material respects when furnished and shall not contain any untrue statements of a material fact or omit to state a material fact necessary in order to make the statements therein not misleading in the light of the circumstances under which such statements were made.

5. The Advisor agrees to keep all information it receives from the Company, its employees and affiliates confidential, except to the extent such information (a) is or becomes generally available to the public (other than as a result of a disclosure by the Advisor), (b) was available to the Advisor on a non-confidential basis from a person other than the Company who, to the knowledge of the Advisor, is not bound by a confidentiality agreement with the Company or otherwise prohibited from transferring such information to the Advisor, (c) the Company agrees may be disclosed, (d) the Advisor is required by law, regulation, legal process or
regulatory authority to disclose and after reasonable notice to the Company, or (e) is required by the Advisor to enforce its rights under this letter. The obligations of the Advisor under the proceeding sentence shall survive the consummation of any Financing Transaction and the termination of the Engagement.

6. For its services in connection with the Engagement, the Company shall pay to the Advisor a non-refundable retainer fee ("Retainer Fee") and a contingent fee, as set forth below (the "Contingent Fee"). The Retainer Fee in the amount of $______ shall be due and payable upon the signing of this Agreement. The Contingent Fee shall be contingent upon the closing of a Financing Transaction and shall be payable on the date of such closing.

7. In the event debt or equity capital is raised by the Advisor on behalf of the Company, the Company shall pay the Advisor the Contingent Fee on closing and funding of each Financing Transaction described below in an amount equal to the following:

(a) _____ percent (____%) of the gross proceeds raised in the private placement of equity or debt which is convertible into equity, so long as such proceeds were raised from investors introduced by the Advisor;

(b) _____ percent (____%) of the gross proceeds raised in the private placement of debt which is subordinated to the Company's primary credit facility; whether such proceeds were raised from investors introduced by the Advisor or otherwise.

(c) Should the Company terminate this engagement:

(i) once the Advisor has entered the private market and delivered the Memorandum to potential institutional investors, but before institutional investors have submitted written proposals, the Company shall pay the Advisor a cash fee equal to $______;

(ii) after institutional investors have submitted written proposals on terms and conditions substantially similar to those contained in the Memorandum, but prior to the Company accepting proposals, the Company will pay the advisor a cash fee of $_____; or

(iii) after the Advisor has arranged for a commitment for the Financing, which has been accepted in writing by the Company, the Company will pay the Advisor a cash fee equal to one-half of the Contingent Fee.

(d) The Advisor shall be entitled to receive full compensation as herein provided if the Company closes any Financing Transaction within twelve months from and after the termination of the Engagement from a party introduced by the Advisor or to whom the Advisor provided the Memorandum on behalf of the Company during the term of the Engagement.

8. In addition to the foregoing fees, the Company shall reimburse the Advisor promptly, on a monthly basis, for all the accountable out-of-pocket expenses (including reasonable legal fees and expenses) incurred by the Advisor
Appendix G: Investment Banking Engagement Agreement

in connection with the Engagement, regardless of whether a Financing Transaction is consummated.

9. In addition, if the Advisor places the private equity/debt placement contemplated herein, the Company shall grant to the Advisor the right of first refusal to serve as a co-managing underwriter of any future public or private offering of common stock or debt, at fees, and upon terms, customary and consistent with industry practice that would be agreed between the Company and the Advisor in good faith. The Company acknowledges that this Agreement is neither an expressed nor an implied commitment by the Advisor to act in any capacity in any such transaction or to purchase or place any securities in connection therewith, which commitment shall only be set forth in a separate underwriting, placement agency or other applicable type of agreement.

10. Whether or not a Financing Transaction is effected, the Company and its affiliates, successors and assigns will jointly and severally indemnify and hold harmless the Advisor and its officers, directors, employees, attorneys, consultants, agents, servants, parents, affiliates, successors and assigns, jointly and severally (hereinafter collectively “Indemnitee”), from and against any and all losses, claims, damages, liabilities, awards, costs and expenses, including but not limited to reasonable attorneys’ fees to which Indemnitee may become subject by virtue of, in connection with, resulting from, or arising out of the Engagement (hereinafter collectively “Claim” or “Claims”). Claims shall include reasonable legal and other expenses, including the cost of any investigation and preparation, incurred by Indemnitee in connection with any pending or threatened Claim by any person or entity, whether or not it results in a loss, damages, liability or award. Indemnitee shall be indemnified and held harmless by the Company for any and all Claims whether they arise under contract, foreign, federal, state or local law or ordinance, common law, or otherwise.

11. Notwithstanding anything above to the contrary: (1) the Advisor shall promptly notify the Company after any Claim is asserted, and the Company shall have the right, upon notification to the Advisor within 10 days thereafter, to assume the defense of such Claim or action and to appoint counsel reasonably satisfactory to Indemnitee to conduct such defense, provided that all expenses and costs related thereto shall be borne by the Company; and (2) the Company shall not be liable for any Claim to the extent that a court having jurisdiction shall have determined by a final, non-appealable, judgment, that such Claim resulted from an Indemnitee’s gross negligence or willful misconduct.

The foregoing indemnification commitment of the Company will survive any termination of the authorization provided by this letter.

The Company agrees to promptly notify the Advisor of any assertion against the Advisor, the Company, or any other person of any Claim or the commencement of any action or proceeding relating to the services comprising the Engagement.

12. The Company agrees that the Advisor has the right to place advertisements in financial and other newspapers and journals at the Advisor’s own expense describing its services to the Company in connection with the
Engagement provided that the Advisor will submit a copy of any such advertise-
ment to the Company for its prior approval, which approval shall not be unre-
asonably withheld or delayed.

13. Either the Company or the Advisor may terminate the Engagement
(except as provided above with respect to any earned Retainer Fee, Contingent
Fee, reimbursement of expenses and indemnification) at any time, with or with-
out cause, effective upon the other party’s receipt of written notice to that effect.

14. This Agreement shall be governed by and construed in accordance
with the laws of _______________

If the foregoing correctly sets forth our agreement, we would appreciate your
signing both enclosed copies of this letter in the space provided below and return-
ing one of them to us. In the event that we do not receive a copy of this letter evi-
dencing your acceptance and agreement within 10 days of the date hereof, the
terms of this letter shall be null and void and of no further force and effect.

Very truly yours,

ADVISOR

Accepted and Agreed:

COMPANY                              ADVISOR
By: ______________________________   By: ______________________________
Title: ___________________________   Title: ______________________________
APPENDIX H

SERIES A PREFERRED STOCK PURCHASE AGREEMENT*

COMPANY

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* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
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EXHIBITS
A Schedule of Purchasers
B Restated Certificate of Incorporation
C Investors’ Rights Agreement
D Stockholder Agreement
E Indemnification Agreement

SCHEDULES
Schedule 3.0—Schedule of Exceptions
SERIES A PREFERRED STOCK PURCHASE AGREEMENT

THIS SERIES A PREFERRED STOCK PURCHASE AGREEMENT (the “Agreement”) is entered into as of this ___ day of September, 2002, by and among the Company (the “Company”), and each of those persons and entities, severally and not jointly, whose names are set forth on the Schedule of Purchasers attached hereto as Exhibit A (which persons and entities are hereinafter collectively referred to as “Purchasers” and each individually as a “Purchaser”).

RECITALS

WHEREAS, the Company has authorized the sale and issuance of up to an aggregate of 1,568,648 shares of its Series A Preferred Stock (the “Series A Stock”);

WHEREAS, Purchasers desire to purchase an aggregate of 1,568,648 shares of Series A Stock (the “Shares”) on the dates specified in Exhibit A; and

WHEREAS, Purchasers desire to purchase the Shares and the Company desires to issue and sell the Shares to the Purchasers on the terms and conditions set forth herein.

NOW, THEREFORE, in consideration of the foregoing recitals and the mutual promises (hereinafter set forth) the parties hereto agree as follows:

SECTION 1. AGREEMENT TO SELL AND PURCHASE

1.1 Authorization of Shares. On or prior to the Initial Closing (as defined in Section 2.1 below), the Company shall have authorized (i) the sale and issuance to Purchasers of the Shares, and (ii) the issuance of such shares of Common Stock to be issued upon conversion of the Shares (the “Conversion Shares”). The Shares shall have the rights, preferences, privileges and restrictions set forth in the Restated Certificate of Incorporation of the Company in the form attached hereto as Exhibit B (the “Certificate”).

1.2 Sale and Purchase. Subject to the terms and conditions hereof, at the respective Closing (as hereinafter defined) set forth on Exhibit A, the Company hereby agrees to issue and sell to each Purchaser, severally and not jointly, and each Purchaser agrees to purchase from the Company, severally and not jointly, the number of Shares set forth opposite such Purchaser’s name on Exhibit A, at a purchase price of $_______ per share.

SECTION 2. CLOSING, DELIVERY AND PAYMENT

2.1 Closings. The initial closing of the sale and purchase of the Shares under this Agreement (the “Initial Closing”) shall take place as set forth on or before ________, 2002 at the offices of Company or at such other time or place as the Company and the Purchasers participating in the Initial Closing may mutually agree (such final date is hereinafter referred to as the “Initial Closing Date”).
Upon fulfillment of the conditions set forth in Section 5.2 the Purchasers and Company shall proceed with the Second Closing (as defined in Exhibit A) and the Final Closing (as defined in Exhibit A) which shall take place as soon as practicable after (a) the Company has informed the Purchasers that such conditions have been met accompanied by financial statements and a letter explaining in reasonable detail how such conditions were met or (b) the Purchasers have waived such conditions. After having received the information in the preceding sentence, the Purchasers shall promptly advise the Company of the meeting or waiver of such conditions on or about the dates of the Second Closing and Final Closing. The Second Closing and Final Closing shall take place at the offices of the Company at a time reasonably acceptable to the Company and the Purchasers.

2.2 Delivery. At each respective Closing, subject to the terms and conditions hereof, the Company will deliver to the Purchasers certificates representing the number of Shares to be purchased at the respective Closing by each Purchaser, against payment of the purchase price therefor by check; or wire transfer made payable to the order of the Company.

SECTION 3. REPRESENTATIONS AND WARRANTIES OF THE COMPANY

Except as otherwise set forth in the Schedule of Exceptions attached to this Agreement as Schedule 3.0, the Company hereby represents and warrants to each Purchaser as set forth in this Section 3. The Company represents and warrants that the Schedule of Exceptions properly references the relevant subsections of this Section 3. The Company represents and warrants that Schedule of Exceptions accurately states in all material respects the exception being made and, to the extent any exception relates to a representation or warranty that includes a materiality threshold amount expressed in dollars, such exception contains a description of the estimated exposure in excess of the materiality threshold amount.

3.1 Organization, Good Standing and Qualification. The Company is a corporation duly organized, validly existing and in good standing under the laws of the State of Delaware. The Company has all requisite corporate power and authority to own and operate its respective properties and assets and to carry on its business as presently conducted and as presently proposed to be conducted, and with respect to the Company to execute and deliver this Agreement, the Investors' Rights Agreement, in the form attached hereto as Exhibit C (the "Investors' Rights Agreement"), and the Stockholder Agreement, in the form attached hereto as Exhibit D (the "Stockholder Agreement") (collectively, the Certificate, Investors' Rights Agreement and the Stockholder Agreement are referred to hereinafter as the "Related Agreements"), to issue and sell the Shares and the Conversion Shares and to carry out the provisions of this Agreement and the Related Agreements. Except as stated in Schedule 3.1, the Company is duly qualified and is authorized to do business and is in good standing in each jurisdiction in which the nature of its activities and of its properties (both owned and leased) makes such qualification necessary except for those jurisdictions in which failure to do so would not have a material
adverse effect on the Company, taken as a whole, or its business. The Company owns no equity securities of any other corporation, limited partnership or similar entity. The Company is not a participant in any joint venture, partnership or similar arrangement. The Due Diligence Materials (as defined below) contain copies of Certificates of Authority for states in which the Company is qualified to do business as a foreign corporation.

3.2 Capitalization: Voting Rights. The authorized capital stock of the Company immediately prior to the Closing, will consist of (i) 40,000,000 shares of Common Stock, 3,661,432 shares of which are issued and outstanding; and 2,125,000 shares of which are reserved for future issuance to directors, employees and consultants pursuant to the Company’s Stock Option Plan; and (ii) 5,000,000 shares of Preferred Stock, 1,568,648 of which are designated Series A Preferred Stock, none of which are issued and outstanding. All issued and outstanding shares of the Company’s Common Stock (i) have been duly authorized and validly issued, (ii) are fully paid and non-assessable; and (iii) were issued in compliance with all applicable state and federal laws concerning the issuance of securities. The rights, preferences, privileges and restrictions of the Shares are as stated in the Certificate. The Conversion Shares have been duly and validly reserved for issuance. Other than as set forth in Section 3.2 of the Schedule of Exceptions, and except as may be granted pursuant to this Agreement and the Related Agreements, there are no outstanding options, warrants, rights (including conversion or preemptive rights and rights of first refusal), proxy or stockholder agreements, or agreements of any kind for the purchase or acquisition from the Company of any of its securities. When issued in compliance with the provisions of this Agreement or the Certificate, as applicable, the Shares and the Conversion Shares will be validly issued, fully paid and non-assessable, and will be free of any liens or encumbrances, preemptive rights or rights of first refusal or transfer; provided, however, that the Shares and the Conversion Shares may be subject to restrictions on transfer under state and/or federal securities laws as set forth herein or as otherwise required by such laws at the time a transfer is proposed. Section 3.2 of the Schedule of Exceptions lists all outstanding debt and equity securities of the Company (or obligations to issue securities), including options granted, the exercise price of such options and the vesting periods of such options. Section 3.2 of the Schedule of Exceptions also includes the price at which the securities were issued and the date of issuance of the securities. Except as set forth in Section 3.2 of the Schedule of Exceptions, or as otherwise provided in this Agreement or in the Related Agreements, there is no plan, agreement or other provision that provides for acceleration or other changes in the securities of the Company (including vesting of options) with respect to any merger, sale of assets, change in control or similar transaction. To the best of the Company’s knowledge, there are no voting agreements, voting trusts or other voting arrangements with respect to the securities of the Company except as may be set forth in the Related Agreements. To the knowledge of the Company each stockholder of the Company whose stock was issued in connection with services has timely filed an election under Section 83(b) of the Code to include into the present period any income attributable to a substantial risk of forfeiture.
3.3 **Authorization: Binding Obligations.** All corporate action on the part of the Company, its officers, directors and stockholders necessary for the authorization of this Agreement, and the Related Agreements, the performance of all obligations of the Company hereunder and thereunder at each respective Closing and the authorization, sale, issuance and delivery of the Shares pursuant hereto has been taken or will be taken prior to the Initial Closing. The Agreement, and the Related Agreements, when executed and delivered, will be valid and binding obligations of the Company enforceable in accordance with their terms, except (i) as limited by applicable bankruptcy, insolvency, reorganization, moratorium or other laws of general application affecting enforcement of creditors’ rights; (ii) as limited by general principles of equity that restrict the availability of equitable remedies; and (iii) to the extent that the enforceability of the indemnification provisions in Section 2.9 of the Investors’ Rights Agreement may be limited by applicable laws. The subsequent conversion of the Shares into Conversion Shares is not and will not be subject to any preemptive rights or rights of first refusal that have not been properly waived or complied with.

3.4 **Financial Statements.** The Company has delivered to each Purchaser (i) its balance sheet as of December 31, 2001 and statement of income for the 12 month period ending December 31, 2001, and (ii) its unaudited balance sheet as of September 30, 2002 (the “Statement Date”) and its unaudited statement of income for the seven months ending on the Statement Date (collectively, the “Financial Statements”). The Financial Statements were prepared in good faith and on a consistent basis and fairly present the financial condition and position of the Company as of their respective dates. The Financial Statements are subject to normal recurring year-end audit adjustments (which are not expected to be material) and do not contain footnotes as required under generally accepted accounting principles. The assumptions used in preparing such Financial Statements were reasonable. Section 3.4 of the Schedule of Exceptions describes the Company’s accounting system, lists the bank and other accounts maintained by the Company and the persons who have signature authority for the Company’s accounts. There are no material compensation or other accounting charges that need to be taken in connection with the issuance of securities by the Company. None of the Company’s options or option plans are required to be accounted for under the variable accounting method except as may be required in the footnotes to the financial statements.

3.5 **Liabilities.** The Company does not have any material liabilities and, to the best of the Company’s knowledge, other than performance obligations under agreements included in the two binders of information delivered to counsel to the investors on ______, 2002 (as supplemented in writing) (the “Due Diligence Materials”), there are no material contingent liabilities not disclosed in the Financial Statements, except current liabilities incurred in the ordinary course of business subsequent to the Statement Date which have not been, either in any individual case or in the aggregate, materially adverse.

3.6 **Agreements.**

(a) Except for agreements explicitly contemplated hereby and agreements between the Company and its employees included in the Due Diligence
Materials with respect to the sale of the Company's Common Stock, there are no agreements, understandings or proposed transactions between the Company and any of the Company's officers, directors, affiliates, or any affiliate thereof.

(b) There are no agreements, understandings, instruments, contracts, proposed transactions, judgments, orders, writs or decrees to which the Company is a party or to its knowledge by which it is bound which may involve (i) obligations (contingent or otherwise) of, or payments to, the Company in excess of $____ or (ii) the license of any patent, copyright, trade secret or other proprietary right to or from the Company (other than licenses arising from the purchase of "off the shelf" or other standard products), or (iii) provisions restricting or affecting the development, manufacture or distribution of the Company's products or services, or (iv) indemnification by the Company with respect to infringements of proprietary rights (other than indemnification obligations arising from purchase or sale agreements entered into in the ordinary course of business).

(c) The Company has not (i) declared or paid any dividends, or authorized or made any distribution upon or with respect to any class or series of its capital stock, (ii) incurred any indebtedness for money borrowed or any other liabilities (other than with respect to dividend obligations, distributions, indebtedness and other obligations incurred in the ordinary course of business or as disclosed in the Financial Statements) individually in excess of $____ or, in the case of indebtedness and/or liabilities individually less than $50,000, in excess of $______ in the aggregate, (iii) made any loans or advances to any person, other than ordinary advances for travel expenses, or (iv) sold, exchanged or otherwise disposed of any of its assets or rights, other than the sale of its inventory in the ordinary course of business.

(d) For the purposes of subsections (b) and (c) above, all indebtedness, liabilities, agreements, understandings, instruments, contracts and proposed transactions involving the same person or entity (including persons or entities the Company has reason to believe are affiliated therewith) shall be aggregated for the purpose of meeting the individual minimum dollar amounts of such subsections.

(e) The Due Diligence Materials contain all true and correct copies of all material agreements of the Company and there has been no written modification, amendment or waiver of any material right or obligation of any such agreement not included with the Due Diligence Materials.

3.7 Obligations to Related Parties. There are no obligations of the Company to officers, directors, stockholders, or employees of the Company other than (i) for payment of salary for services rendered since the commencement of the Company's most recent payroll period, (ii) reimbursement for reasonable expenses incurred on behalf of the Company, and (iii) for other standard employee benefits made generally available to all employees. None of the officers, directors or stockholders of the Company, or any members of their immediate families, are indebted to the Company or have any direct or indirect ownership interest in any firm or corporation with which the Company is affiliated or with which the Company has a business relationship, or any firm or corporation which competes
with the Company, except that officers, directors and/or stockholders of the Company may own stock in publicly traded companies which may compete with the Company. No officer, director or stockholder, or any member of their immediate families, is, directly or indirectly, interested in any material contract with the Company (other than such contracts as relate to any such person's ownership of capital stock or other securities of the Company). Except as may be disclosed in the Financial Statements, the Company is not a guarantor or indemnitor of any indebtedness of any other person, firm or corporation.

3.8 Changes. Since the Statement Date, there has not been:

(a) Any change in the assets, liabilities, financial condition or operations of the Company from that reflected in the Financial Statements, other than changes in the ordinary course of business, including the continued incurrence of losses in the ordinary course of business, none of which individually or in the aggregate has had or is expected to have a material adverse effect on such assets, liabilities, financial condition or operations of the Company (taken as a whole);

(b) Any resignation or termination of any officer of the Company and the Company, to the best of its knowledge, does not know of the impending resignation or termination of employment of any such officer;

(c) Any material change, except in the ordinary course of business, in the contingent obligations of the Company by way of guaranty, endorsement, indemnity, warranty or otherwise;

(d) Any damage, destruction or loss, whether or not covered by insurance, materially and adversely affecting the properties, business or prospects or financial condition of the Company (taken as a whole);

(e) Any waiver by the Company of a valuable right or of a material debt owed to it;

(f) Any direct or indirect loans made by the Company to any stockholder, employee, officer or director of the Company, other than advances made in the ordinary course of business;

(g) Any material change in any compensation arrangement or agreement with any employee, officer, director or stockholder of the Company;

(h) Any declaration or payment of any dividend or other distribution of the assets of the Company;

(i) Any labor organization activity;

(j) Any debt, obligation or liability incurred, assumed or guaranteed by the Company, except those for immaterial amounts and for current liabilities incurred in the ordinary course of business;

(k) Any sale, assignment or transfer of any patents, trademarks, copyrights, trade secrets or other intangible assets of the Company other than licenses in the ordinary course of business;
(l) Any change in any material agreement to which the Company is a party or by which it is bound which materially and adversely affects the business, assets, liabilities, financial conditions, operations, or prospects of the Company, including compensation agreements with the Company's employees; or

(m) Any other event or condition of any character that, either individually or cumulatively, has materially and adversely affected the business, assets, liabilities, financial condition, operations, or prospects of the Company, taken as a whole.

3.9 Title to Properties and Assets: Liens, etc. The Company has good and marketable title to its properties and assets, including the properties and assets reflected in the most recent balance sheet included in the Financial Statements, and good title to its leasehold estates, in each case subject to no mortgage, pledge, lien, lease, encumbrance or charge, other than (i) those resulting from taxes which have not yet become delinquent, (ii) minor liens and encumbrances which do not materially detract from the value of the property subject thereto or materially impair the operations of the Company (and do not exceed $_______ in the aggregate); and (iii) those that have otherwise arisen outside the ordinary course of business (and do not exceed $______ in the aggregate). All facilities, machinery, equipment, fixtures, vehicles and other properties owned, leased or used by the Company are in good operating condition and repair and are reasonably fit and usable for the purposes for which they are being used. The Due Diligence Materials contain true and correct copies of all leases of the Company that require payment of $______ or more in any year.

3.10 Patents and Trademarks. The Company owns or possesses sufficient legal rights to all trademarks, service marks, trade names, copyrights, trade secrets and licenses, and, to the knowledge of the Company, to all patents, information and other proprietary rights and processes necessary for its business as now conducted and as proposed to be conducted, without any known infringement of the rights of others. There are no outstanding options, licenses or agreements of any kind relating to the foregoing, nor is the Company bound by or a party to any options, licenses or agreements of any kind with respect to the patents, trademarks, service marks, trade names, copyrights, trade secrets, licenses, information and other proprietary rights and processes of any other person or entity other than such licenses or agreements arising from the purchase of “off the shelf” or standard products. The Company has not received any communications alleging that the Company has violated or, by conducting its business as proposed, would violate any of the patents, trademarks, service marks, trade names, copyrights or trade secrets or other proprietary rights of any other person or entity. The Company is not aware that any of its respective employees is obligated under any contract (including licenses, covenants or commitments of any nature) or other agreement, or subject to any judgment, decree or order of any court or administrative agency, that would interfere with their duties to the Company or that would conflict with the Company's business as proposed to be conducted. Neither the execution nor delivery of this Agreement, nor the carrying on of the Company's business by the employees of the Company, nor the conduct of the Company's business as proposed, will, to the Company's knowledge, conflict with or result in
a breach of the terms, conditions or provisions of, or constitute a default under, any contract, covenant or instrument under which any employee is now obligated. The Company does not believe it is or will be necessary to utilize any inventions, trade secrets or proprietary information of any of its respective employees made prior to their employment by the Company, except for inventions, trade secrets or proprietary information that have been assigned to the Company. Section 3.10 of the Schedule of Exceptions lists all domain names, patents, patent applications, trademarks, trademark registration filings and registered copyrights of the Company. Section 3.10 of the Schedule of Exceptions lists all third party software used by the Company either internally or as part of its business to customers ("Third Party Software"). All Third Party Software is duly licensed and there are no unpaid license fees, royalties or other fees except on-going maintenance at commercially reasonable rates. Section 3.10 describes agreements under which the Company has, or has granted, source code rights, including escrows. All software developed by the Company's employees or contractors has been developed as "work-for-hire" without such employee or contractor retaining any rights or requiring the Company to make any payments except salary or hourly consulting fees.

3.11 Compliance with Other Instruments. The Company is not in violation or default of (i) any term of its Certificate of Incorporation or Bylaws, (ii) any material provision of any mortgage, indenture, contract, agreement, instrument or contract to which it is party or by which it is bound, (iii) any judgment, decree, order or writ, or (iv) any statute, rule or regulation applicable to the Company which would materially and adversely affect the business, assets, liabilities, financial condition, operations or prospects of the Company. The execution, delivery, and performance of and compliance with this Agreement and the issuance and sale of the Shares pursuant hereto and of the Conversion Shares pursuant to the Certificate will not, with or without the passage of time or giving of notice, result in any such material violation, or be in conflict with or constitute a default under any such term, or result in the creation of any mortgage, pledge, lien, encumbrance or charge upon any of the properties or assets of the Company or the suspension, revocation, impairment, forfeiture or nonrenewal of any permit license, authorization or approval applicable to the Company, its business or operations or any of its assets or properties.

3.12 Litigation. There is no action, suit, proceeding or investigation pending or to the Company's knowledge currently threatened against the Company that questions (i) the validity of this Agreement or the Related Agreements, (ii) the right of the Company to enter into any of such agreements, or to consummate the transactions contemplated hereby or thereby, or (iii) which might result, either individually or in the aggregate, in any material adverse change in the assets, condition, affairs or prospects of the Company, financially or otherwise, or any change in the current equity ownership of the Company, nor is the Company aware that there is any basis for the foregoing. The foregoing includes, without limitation, actions pending or threatened (or any basis therefor known to the Company) involving the prior employment of any of the Company's respective employees, their use in connection with the Company's business of any information or techniques allegedly proprietary to any of their former employers, or their obligations under any agreements with prior employers. The Company is not a
party or subject to the provisions of any order, writ, injunction, judgment or decree of any court or government agency or instrumentality. There is no action, suit, proceeding or investigation by the Company currently pending or which the Company intends to initiate.

3.13 **Tax Returns and Payments.** The Company has timely filed all tax returns (federal, state and local) required to be filed by it. All taxes shown to be due and payable on such returns, any assessments imposed, and all other taxes due and payable by the Company on or before the Closing have been paid or will be paid prior to the time they become delinquent. The Company has not been advised (i) that any of its returns, federal, state or other, have been or are being audited as of the date hereof, or (ii) of any deficiency in assessment or proposed judgment to its federal, state or other taxes. There is no material liability for any tax to be imposed upon the properties or assets of the Company as of the date of this Agreement that is not adequately reserved for in the Financial Statements. The Due Diligence Materials contain true and correct copies of all tax returns filed by the Company.

3.14 **Employees.** The Company does not have any collective bargaining agreements with any of its respective employees. There is no labor union organizing activity pending or, to the Company's knowledge, threatened with respect to the Company. No employee has any agreement or contract, written or verbal, regarding his employment except as provided in this Agreement or the Related Agreements. The Company is not a party to or bound by any currently effective employment contract, deferred compensation arrangement, bonus plan, incentive plan, profit sharing plan, retirement agreement or other employee compensation plan or agreement. To the Company's knowledge, no employee of the Company, nor any consultant with whom the Company has contracted, is in violation of any term of any employment contract, proprietary information agreement or any other agreement relating to the right of any such individual to be employed by, or to contract with, the Company because of the nature of the business to be conducted by the Company; and to the Company's knowledge the continued employment by the Company of their respective present employees, and the performance of the Company's respective contracts with its independent contractors, will not result in any such violation. The Company has not received any notice alleging that any such violation has occurred. No employee of the Company has been granted the right to continued employment by the Company or to any material compensation following termination of employment with the Company. The Company is not aware that any officer or key employee, or that any group of key employees, intends to terminate their employment with the Company, nor does the Company have a present intention to terminate the employment of any officer, key employee or group of key employees. Section 3.14 of the Schedule of Exceptions sets forth the current compensation of each officer of the Company and the compensation (base salary and bonuses) for the period from the closing to December 31, 2001 on an annual basis, without giving effect to any bonuses declared by the Board of Directors from and after the date hereof. No employee or consultant has any accrued or unpaid salary at the Initial Closing except for partial month periods in the ordinary course of business.
3.15 Registration Rights. Except as required pursuant to the Investors' Rights Agreement, the Company is presently not under any obligation, and has not granted any rights, to register (as defined in Section 1.1 of the Investors' Rights Agreement) any of the Company's presently outstanding securities or any of its securities that may hereafter be issued.

3.16 Compliance with Laws; Permits. The Company is not in violation of any applicable statute, rule, regulation, order or restriction of any domestic or foreign government or any instrumentality or agency thereof in respect of the conduct of its business or the ownership of its properties which violation would materially and adversely affect the business, assets, liabilities, financial condition, operations or prospects of the Company. Without limiting the foregoing, the Company will confirm to the Purchasers at or before the Second Closing that the Company is not required to be licensed as a "Third Party Administrator" and/or required to obtain any other license from, any state insurance department or commission in order for it to perform services for its customers or to otherwise execute its business plan. No governmental orders, permissions, consents, approvals or authorizations are required to be obtained and no registrations or declarations are required to be filed in connection with the execution and delivery of this Agreement and the issuance of the Shares, except such as have been duly and validly obtained or filed, or with respect to any filings that must be made after each respective Closing, as defined in Exhibit A. The Company shall use its best efforts to file any documents required to be filed as a result of any Closing in a reasonable time period. The Company has all franchises, permits, licenses and any similar authority necessary for the conduct of its business as now being conducted by it, the lack of which could materially and adversely affect the business, properties or financial condition of the Company and believes it can obtain, without undue burden or expense, any similar authority for the conduct of its business as planned to be conducted.

3.17 Environmental and Safety Laws. The Company is not in violation of any applicable statute, law or regulation relating to the environment or occupational health and safety, and no material expenditures are, or to the Company's knowledge will be, required in order to comply with any such existing statute, law or regulation.

3.18 Offering Valid. Assuming the accuracy of the representations and warranties of the Purchasers contained in Section 4.2 hereof, the offer, sale and issuance of the Shares and the Conversion Shares will be exempt from the registration requirements of the Securities Act of 1933, as amended (the "Securities Act"). Neither the Company nor any agent on its behalf has solicited or will solicit any offers to sell, or has offered to sell or will offer to sell all or any part of the Shares to any person or persons so as to bring the sale of such Shares by the Company within the registration provisions of the Securities Act.

3.19 Full Disclosure. This Agreement, the Exhibits hereto, the Related Agreements and any certificate delivered by the Company to Purchasers or their attorneys or agents in connection herewith or therewith or with the transactions contemplated hereby or thereby, do not contain any untrue statement of a material fact nor omits to state a material fact necessary in order to make the state-
ments contained herein or therein not misleading, taken as a whole in light of the circumstances under which they were made.

3.20 **Minute Books.** The copies of the minute books of the Company included in the Due Diligence Materials contain complete copies of minutes of all meetings and written consents of directors and stockholders since the time of incorporation.

3.21 **Real Property Holding Corporation.** The Company is not a real property holding corporation within the meaning of Internal Revenue Code Section 897(c)(2) and any regulations promulgated thereunder.

3.22 **ERISA.** The Company has complied in all material respects with the applicable rules and regulations of the Employee Retirement Income Security Act of 1974, as amended, with respect to any employee benefit plans subject thereto.

3.23 **Exchange Act Compliance.** At such time as the Company becomes subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), the Company will use reasonable efforts to timely file all required reports under the Exchange Act in order to enable investors to use Rule 144 of the Act in connection with transfers of Shares or Conversion Shares. At such time as any Shares or Conversion Shares are eligible for transfer under Rule 144(k) of the Act, the Company will remove or cause to have removed any restrictive legend on such certificates evidencing the Shares or Conversion Shares upon written request from the registered holder of the Shares or Conversion Shares. Such holder shall provide any information reasonably requested by the Company or its counsel to facilitate such removal. The Company will use its best efforts to facilitate such removal within 30 days of receipt of such request.

3.24 **Insurance.** The Company has obtained commercially reasonable insurance to operate its business.

3.25 **Company Actions Prior to Second and Final Closing.** The Company will use its commercially reasonable best efforts to fulfill all conditions applicable to it that must be fulfilled after the Initial Closing and prior to each of the Second and Final Closings. The Company shall not take any action after the Initial Closing and prior to the Second Closing that would modify or adversely affect the rights of the Purchasers as described herein and in the Related Agreements.

3.26 **Knowledge.** For purposes of this Section 3, the term “knowledge” means with respect to the Company on any matter in question, whether any of the executive officers or directors of the Company has actual knowledge of such matter.

3.27 **Merger.** The Agreement of Merger between _____________, a Delaware corporation (the “Predecessor”), and the Company are legal, valid, binding, enforceable and in full force and effect under the laws of the State of Delaware, and the Company continues as the sole surviving entity with all of the rights and assets of the Predecessor. There are no liabilities or obligations of the Predecessor not set forth in this Agreement, the Schedule of Exceptions or the Due Diligence Materials.
SECTION 4. REPRESENTATIONS AND WARRANTIES OF THE PURCHASERS

Each Purchaser hereby represents and warrants to the Company as of the Closing, as follows (such representations and warranties do not lessen or obviate the representations and warranties of the Company set forth in this Agreement):

4.1 Requisite Power and Authority. Purchaser has all necessary power and authority under all applicable provisions of law to execute and deliver this Agreement and the Related Agreements and to carry out their provisions. All action on Purchaser's part required for the lawful execution and delivery of this Agreement and the Related Agreements have been or will be effectively taken prior to the Closing. Upon their execution and delivery, this Agreement and the Related Agreements will be valid and binding obligations of Purchaser, enforceable in accordance with their terms, except (i) as limited by applicable bankruptcy, insolvency, reorganization, moratorium or other laws of general application affecting enforcement of creditors' rights, (ii) as limited by general principles of equity that restrict the availability of equitable remedies and (iii) to the extent that the enforceability of the indemnification provisions of Section 2.9 of the Investors' Rights Agreement may be limited by applicable laws.

4.2 Investment Representations. Purchaser understands that the Shares and the Conversion Shares have not been registered under the Securities Act. Purchaser also understands that the Shares are being offered and sold pursuant to an exemption from registration contained in the Securities Act based in part upon Purchaser's representations contained in this Agreement. Purchaser hereby represents and warrants as follows:

(a) Purchaser Bears Economic Risk. Purchaser is an "accredited investor" as that term is defined under Rule 501 of Regulation D of the Securities Act. Purchaser has substantial experience in evaluating and investing in private placement transactions of securities in companies similar to the Company so that it is capable of evaluating the merits and risks of its investment in the Company and has the capacity to protect its own interests. Purchaser understands that an investment in the Company involves a high degree of risk. Purchaser must bear the economic risk of this investment indefinitely unless the Shares or the Conversion Shares are registered pursuant to the Securities Act, or an exemption from registration is available. Purchaser understands that the Company has no present intention of registering the Shares or the Conversion Shares or any shares of its Common Stock except as set forth in the Agreement and in the Investors' Rights Agreement. Purchaser also understands that there is no assurance that any exemption from registration under the Securities Act will be available and that, even if available, such exemption may not allow Purchaser to transfer all or any portion of the Shares or the Conversion Shares under the circumstances, in the amounts or at the times Purchaser might propose.

(b) Acquisition for Own Account. Purchaser is acquiring the Shares and the Conversion Shares for Purchaser's own account for investment only, and not as a nominee and not with a view to their distribution or resale.
has not taken and will not take or cause to be taken any action that would cause it to be deemed an underwriter, as defined in Section 2(11) of the Securities Act, with respect to the Shares or the Conversion Shares.

(c) **Purchaser Can Protect Its Interest.** Purchaser represents that by reason of its, or of its management's, business or financial experience, Purchaser has the capacity to protect its own interests in connection with the transactions contemplated in this Agreement, and the Related Agreements. Further, Purchaser is not aware of the publication of any advertisement in connection with the transactions contemplated in the Agreement.

(d) **Company Information.** Purchaser has received and read the Financial Statements and has had an opportunity to discuss the Company's business, management and financial affairs with directors, officers and management of the Company, and has had the opportunity to review the Company's operations and facilities. Purchaser has also had the opportunity to ask questions of and receive answers from the Company and its management regarding the terms and conditions of this investment, and Purchaser desires no additional information with respect to the Company and this investment.

(e) **Rule 144.** Purchaser acknowledges and agrees that the Shares, and if issued, the Conversion Shares must be held indefinitely unless they are subsequently registered under the Securities Act or an exemption from such registration is available. Purchaser has been advised by its own advisors or is aware of the provisions of Rule 144 promulgated under the Securities Act, as in effect from time to time, which permits limited resale of shares purchased in a private placement subject to the satisfaction of certain conditions, including, among other things, the availability of certain current public information about the Company, the resale occurring following the required holding period under Rule 144, and the number of shares being sold during any three month period not exceeding specified limitations.

4.3 **Transfer Restrictions.** Each Purchaser acknowledges and agrees that the Shares and, if issued, the Conversion Shares are subject to restrictions on transfer as set forth in the Investors' Rights Agreement.

4.4 **Legends.** Each Purchaser understands and acknowledges that the certificate evidencing its Shares and, if issued, the Conversion Shares will be imprinted with a legend in the form set forth in Section 2.1 of the Investors Rights Agreement.

**SECTION 5. CONDITIONS TO CLOSING**

5.1 **Conditions to Purchasers' Obligations at Initial Closing.** Each Purchaser's obligation to purchase the Shares at the Initial Closing is subject to the satisfaction, at or prior to the Initial Closing, of the following conditions:

(a) **Representations and Warranties True: Performance of Obligations.** The representations and warranties made by the Company in Section 3 hereof shall be true and correct in all material respects as of the Closing Date
with the same force and effect as if they had been made as of the Closing Date, and the Company shall have performed all obligations and conditions herein required to be performed or observed by it on or prior to the Closing.

(b) **Legal Investment.** On the Closing Date, the sale and issuance of the Shares and the proposed issuance of the Conversion Shares shall be legally permitted by all laws and regulations to which Purchasers and the Company are subject.

(c) **Consents, Permits, and Waivers.** The Company shall have obtained any and all consents, permits and waivers necessary or appropriate for consummation of the transactions contemplated by the Agreement and the Related Agreements (except for such as may be properly obtained subsequent to the Closing).

(d) **Filing of Certificate.** The Certificate shall have been filed with the Secretary of State of the State of Delaware and shall be in full force and effect.

(e) **Corporate Documents.** The Company shall have delivered to Purchasers or their counsel copies of all corporate documents of the Company as Purchasers shall reasonably request.

(f) **Reservation of Conversion Shares.** The Conversion Shares issuable upon conversion of the Shares shall have been duly authorized and reserved for issuance upon such conversion.

(g) **Compliance Certificate.** The Company shall have delivered to Purchasers a Compliance Certificate, executed by the Chief Executive Officer and Vice President of Finance of the Company, dated the date of the Closing, to the effect that the conditions specified in subsections (a), (c), (d) and (f) of this Section 5.1 have been satisfied.

(h) **Investors’ Rights Agreement.** An Investors’ Rights Agreement, substantially in the form attached hereto as Exhibit C, shall have been executed and delivered by the parties thereto.

(i) **Indemnification Agreement.** An Indemnification Agreement, substantially in the form attached hereto as Exhibit E, shall have been executed and delivered by the parties thereto.

(j) **Board of Directors.** Upon the Initial Closing, the Company’s Bylaws shall provide for a Board of Directors of no less than one or more than five directors and the Board of Directors shall include _________________, the director chosen by the Holders of Series A Preferred Stock pursuant to the Certificate.

(k) **Minimum Investment at Initial Closing.** The Purchasers shall purchase at least 470,589 Shares at the Initial Closing, as set forth in Exhibit A hereto.

(l) **SBA Matters.** The Company shall have executed and delivered to each SBIC Purchaser a Size Status Declaration on SBA Form 480 and an Assurance of Compliance on SBA Form 652, and shall have provided to each such
Purchaser information necessary for the preparation of a Portfolio Finance Report on SBA Form 1031.

(m) Satisfactory Completion of Pre-Investment Review. The Purchasers participating in the Initial Closing shall have completed their pre-investment investigation and review of the Company’s business, condition, assets, liabilities, operations, financial performance and prospects and shall be satisfied with the results of such investigation and review.

(n) Proceedings and Documents. All corporate and other proceedings in connection with the transactions contemplated at the Closing hereby and all documents and instruments incident to such transactions shall be reasonably satisfactory in substance and form to the Purchasers and their counsel, and the Purchasers and their counsel shall have received all such counterpart originals or certified or other copies of such documents as they may reasonably request.

(o) Operational Requirements. The Company shall have satisfied the revenue and net income requirements as set forth in the Exhibit A unless otherwise waived by the Purchaser.

(p) Non-Compete. Each of the Key Employees (as defined below) shall have executed a delivered a Non-Competition Agreement reasonably acceptable to the Purchasers.

(q) Employees. At or prior to the Initial Closing, the Company shall have engaged ______________________ (collectively, the “Key Employees”) as full time employees of the Company. To the best of the Company’s knowledge, the Key Employees have no other known or anticipated employment obligations.

(r) Management Stock. Outstanding shares of Common Stock owned by _________ (“Management Stock”) shall be subject to buy-back provisions which are acceptable to the Purchasers.

(s) Proprietary Information Agreements. Each employee, and every consultant currently under contract to the Company that has access to or developed confidential information of the Company, shall have executed and delivered the Employee/Contractor Nondisclosure Agreement (“Nondisclosure Agreement”) in the form substantially similar to that set forth in Section 9(j) of the Due Diligence Materials that the Purchasers have agreed is reasonably acceptable. The Company has secured executed Nondisclosure Agreements from all such persons and has given the persons executing such agreements sufficient consideration to make the agreements enforceable. All future employees and every future consultant under contract that has access to or develops confidential information of the Company will execute and deliver the Nondisclosure Agreement in the form substantially similar to that set forth in Section 9(j) of the Due Diligence Materials.

(t) Legal Opinion. The Company’s counsel shall have rendered its opinion as to the issuance of the shares and related matters in a form reasonably acceptable to the Purchasers.
5.2 Conditions to Purchasers’ Obligations at Second and Final Closings. Each Purchaser’s obligation to purchase the Shares at each of the Second Closing and Final Closing is subject to the satisfaction, at or prior to the respect Closing:

(a) Representations and Warranties True. The representations and warranties made by the Company in Section 3 hereof shall be true and correct in all material respects as of the respective Closing, except for changes in the ordinary course of business which are not in the aggregate materially adverse to the Company’s business;

(b) Financial Milestones. The Company shall have achieved, or the Purchasers shall have waived, the financial milestones for each respective Closing set forth on Exhibit A.

(c) Key Person Insurance. The Company shall have obtained key person insurance in the amount of $__________ on each Key Employee except ____________________.

(d) Compliance Certificate. The Company shall have delivered to Purchasers a Compliance Certificate, executed by the Chief Executive Officer of the Company, dated the date of the Closing, to the effect that the conditions specified in subsections (a), (b) and (c) of this Section 5.2 have been satisfied.

5.3 Conditions to Obligations of the Company at the Initial Closing, Second Closing and Final Closing. The Company’s obligation to issue and sell the Shares at each Closing is subject to the satisfaction, on or prior to each such Closing, of the following conditions:

(a) Representations and Warranties True. The representations and warranties made by the Purchasers in Section 4 hereof shall be true and correct in all material respects at the date of the Closing, with the same force and effect as if they had been made on and as of said date.

(b) Performance of Obligations. Purchasers shall have performed and complied with all agreements and conditions herein required to be performed or complied with by Purchasers on or before the Closing.

(c) Filing of Certificate. The Certificate shall have been filed with the Secretary of State of the State of Delaware and shall be in full force and effect.

(d) Investors’ Rights Agreement. An Investors’ Rights Agreement, substantially in the form attached hereto as Exhibit C, shall have been executed and delivered by the parties thereto.

(e) Payment of Purchase Price. Each Purchaser shall have delivered to the Company the purchase price for such Purchaser’s Shares in the amount set forth opposite such Purchaser’s name on Exhibit A.

SECTION 6. MISCELLANEOUS

6.1 Governing Law. This Agreement shall be governed in all respects by the laws of the State of Delaware.
6.2 **Survival.** The representations, warranties, covenants and agreements made herein shall survive any investigation made by any Purchaser and the closing of the transactions contemplated hereby. All statements as to factual matters contained in any certificate or other instrument delivered by or on behalf of the Company pursuant hereto in connection with the transactions contemplated hereby shall be deemed to be representations and warranties by the Company hereunder solely as of the date of such certificate or instrument.

6.3 **Successors and Assigns.** Except as otherwise expressly provided herein, the provisions hereof shall inure to the benefit of, and be binding upon, the successors, assigns, heirs, executors and administrators of the parties hereto and shall inure to the benefit of and be enforceable by each person who shall be a holder of the Shares or the Conversion Shares from time to time.

6.4 **Entire Agreement.** This Agreement, the Exhibits and Schedules hereto, the Related Agreements and the other documents delivered pursuant hereto constitute the full and entire understanding and agreement between the parties with regard to the subjects hereof and no party shall be liable or bound to any other in any manner by any representations, warranties, covenants and agreements except as specifically set forth herein and therein.

6.5 **Severability.** In case any provision of the Agreement 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.

6.6 **Amendment and Waiver.**

(a) This Agreement may be amended or modified only upon the written consent of the Company and the holders of at least a majority of the then-outstanding Shares (treated as if converted).

(b) The obligations of the Company and the rights of the holders of the Shares and the Conversion Shares under the Agreement may be waived only with the written consent of the holders of at least a majority of the then-outstanding Shares (treated as if converted).

(c) Notwithstanding the foregoing subsections (a) and (b), no amendment or waiver of any of the following shall be effective against any Purchaser without the consent of that Purchaser:

(i) waiver or amendment of any condition of any Closing;

(ii) waiver or amendment of any representation or warranty of the Company or any breach thereof;

(iii) any other amendment that affects a Purchaser materially and adversely differently than another Purchaser.

6.7 **Delays or Omissions.** It is agreed that no delay or omission to exercise any right, power or remedy accruing to any party, upon any breach, default or noncompliance by another party under this Agreement or the Related
Agreements, shall impair any such right, power or remedy, nor shall it be construed to be a waiver of any such breach, default or noncompliance, or any acquiescence therein, or of or in any similar breach, default or noncompliance thereafter occurring. It is further agreed that any waiver, permit, consent or approval of any kind or character on any Purchaser’s part of any breach, default or noncompliance under this Agreement or the Related Agreements or any waiver on such party’s part of any provisions or conditions of this Agreement or the Related Agreements must be in writing and shall be effective only to the extent specifically set forth in such writing. All remedies, either under this Agreement, the Related Agreements, by law, or otherwise afforded to any party, shall be cumulative and not alternative.

6.8 Notices. All notices required or permitted hereunder shall be in writing and shall be deemed effectively given: (i) upon personal delivery to the party to be notified; (ii) when sent by confirmed telex or facsimile if sent during normal business hours of the recipient, or, if not, then on the next business day, (iii) three business days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (iv) one day after deposit with a nationally recognized overnight courier, specifying next-day delivery. All communications shall be sent to the Company at the address as set forth on the signature page hereof and to Purchaser at the address set forth on the signature page hereof or at such other address as the Company or Purchaser may designate by ten days advance written notice to the other parties hereto.

6.9 Expenses. The Company shall pay all costs and expenses that it incurs with respect to the negotiation, execution, delivery and performance of the Agreement. It is the Company’s responsibility to draft all required documents. The Company shall pay at Closing, or promptly following, the reasonable legal fees and expenses (not to exceed $_____) incurred by counsel to the Purchasers, in connection with the negotiation, execution, delivery and performance of this Agreement. The Company will reimburse the Purchasers at or promptly following the Closing for any other reasonably incurred out-of-pocket costs.

6.10 Attorneys’ Fees. In the event that any dispute among the parties to this Agreement should result in litigation, the prevailing party in such dispute shall be entitled to recover from the losing party all fees, costs and expenses of enforcing any right of such prevailing party under or with respect to this Agreement, including without limitation, such reasonable fees and expenses of attorneys and accountants, which shall include, without limitation, all fees, costs and expenses of appeals.

6.11 Titles and Subtitles. The titles of the sections and subsections of the Agreement are for convenience of reference only and are not to be considered in construing the terms of this Agreement.

6.12 Broker’s Fees. Each party hereto represents and warrants that no agent, broker, investment banker, person or firm acting on behalf of or under the authority of such party hereto is or will be entitled to any broker’s or finder’s fee or any other commission directly or indirectly in connection with the transactions
contemplated herein. Each party hereto further agrees to indemnify each other party for any claims, losses or expenses incurred by such other party as a result of the representation in this Section 6.13 being untrue.

6.13 Exculpation Among Purchasers. Each Purchaser acknowledges that it is not relying upon any person, firm, or corporation, other than the Company and its officers and directors, in making its investment or decision to invest in the Company. Each Purchaser agrees that no Purchaser, nor the respective controlling persons, officers, directors, partners, agents, or employees of any Purchaser, shall be liable for any action heretofore or hereafter taken or omitted to be taken by any of them in connection with the Shares and Conversion Shares.

6.14 Pronouns. All pronouns contained herein, and any variations thereof, shall be deemed to refer to the masculine, feminine or neutral, singular or plural, as to the identity of the parties hereto may require.

6.15 Counterparts. This Agreement may be executed in two or more counterparts, any one of which need not contain the signatures of more than one party, but all such counterparts when taken together shall constitute one and the same Agreement.
IN WITNESS WHEREOF, the parties hereto have executed the Series A Preferred Stock Purchase Agreement as of the date set forth in the first paragraph hereof.

<table>
<thead>
<tr>
<th>COMPANY</th>
<th>PURCHASERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>COMPANY</td>
<td>PURCHASER 1</td>
</tr>
<tr>
<td>By: ______________________</td>
<td>By: ______________________</td>
</tr>
<tr>
<td>Address: __________________</td>
<td>Address: __________________</td>
</tr>
<tr>
<td>Date: ____________________</td>
<td>Date: ____________________</td>
</tr>
</tbody>
</table>

PURCHASER 2

| By: ______________________ |
| Address: __________________ |
| Date: ____________________ |

PURCHASER 3

| By: ______________________ |
| Address: __________________ |
| Date: ____________________ |
**EXHIBIT A**

**SCHEDULE OF PURCHASERS**

The following Purchasers shall purchase the number of Shares for the Purchase Price set forth opposite their names:

<table>
<thead>
<tr>
<th>Purchaser</th>
<th>Number of Shares</th>
<th>Aggregate Purchase Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchaser 1</td>
<td>1,176,486</td>
<td>$ _______</td>
</tr>
<tr>
<td>Purchaser 2</td>
<td>128,627</td>
<td>$ _______</td>
</tr>
<tr>
<td>Purchaser 3</td>
<td>39,216</td>
<td>$ _______</td>
</tr>
<tr>
<td>Purchaser 4</td>
<td>39,216</td>
<td>$ _______</td>
</tr>
<tr>
<td>Purchaser 5</td>
<td>9,412</td>
<td>$ _______</td>
</tr>
<tr>
<td>Purchaser 6</td>
<td>19,608</td>
<td>$ _______</td>
</tr>
<tr>
<td>Other Series A Investors, as set forth on the signature pages to the Purchase Agreement</td>
<td>156,083</td>
<td>$ _______</td>
</tr>
</tbody>
</table>
The funds will be distributed to the Company by the Purchasers as follows on the following dates:

**SEPTEMBER ____, 2002 CLOSING**

("INITIAL CLOSING")

<table>
<thead>
<tr>
<th>Name</th>
<th>Aggregate Purchase Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchaser 1</td>
<td>$_______</td>
</tr>
<tr>
<td>Purchaser 2</td>
<td>$_______</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>$_______</td>
</tr>
</tbody>
</table>

**OCTOBER ____, 2002 CLOSING**

("SECOND CLOSING")

<table>
<thead>
<tr>
<th>Name</th>
<th>Aggregate Purchase Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchaser 1</td>
<td>$_______</td>
</tr>
<tr>
<td>Purchaser 2</td>
<td>$_______</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>$_______</td>
</tr>
</tbody>
</table>

**JANUARY ____, 2003 CLOSING**

("FINAL CLOSING")

<table>
<thead>
<tr>
<th>Name</th>
<th>Aggregate Purchase Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchaser 1</td>
<td>$_______</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td>$_______</td>
</tr>
</tbody>
</table>

1 The Purchase Price per Share is $_____.

2 Except as set forth in Section 5.2, there are no additional conditions to Closing that must be met.

3 The Company must satisfy third quarter revenue and net income requirements as follows:
   - Revenues must be a minimum of $____;
   - Software Revenue must be a minimum of $____; and
   - Net Loss must not exceed $____.

4 The Company must satisfy third and fourth quarter combined revenue and net income requirements as follows:
   - Revenues must be a minimum of $____;
   - Software Revenues must be a minimum of $____; and
   - Net Loss must not exceed $____.
   - With respect to notes 3 and 4 above, all amounts are determined according to Company practice using accrual accounting and applying revenue recognition policies consistent with Staff Accounting Bulletin 101.
EXECUTIVE EMPLOYMENT AGREEMENT effective September 1, 2002 (the "Agreement") by and between Company (the "Company"), with principal offices located at ____________________________, and Executive (the "Executive").

NOW THEREFORE, in consideration of the foregoing premises and mutual covenants herein contained, the parties hereto agree as follows:

1. **Employment.** The Company agrees to employ the Executive and the Executive agrees to serve the Company as its Chief Executive Officer.

2. **Position and Responsibilities.** The Executive shall exert his best efforts and devote full time and attention to the affairs of the Company. The Executive shall be in charge of formulating the general policy and direction of the Company and shall have full authority and responsibility with respect thereto, subject to the general direction, approval and control of the Board of Directors and to the restrictions, limitations and guidelines set forth by the Board of Directors. His powers shall include the authority to hire and fire personnel of the Company except for members of the Board of Directors and to retain consultants when he deems necessary in order to implement Company policies.

3. **Board of Directors.** The Executive shall at all times discharge his duties in consultation with and under the supervision of the Board of Directors of the Corporation. In the performance of his duties the Executive shall make his principal office at the corporate headquarters of the Company in __________. The Company may require the Executive to relocate to another facility located within 30 miles of the city limits of __________, during the term hereof. Any other relo-

* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
cation shall be subject to Executive’s prior agreement and approval in Executive’s sole discretion.

4. **Term of Employment.** The term of the Executive’s employment under this Agreement shall be deemed to have commenced on September 1, 2002 and shall continue for a three-year period until August 31, 2005, subject to extension or termination as hereinafter provided. Provided that Executive is in compliance with all of his obligations hereunder, the term of Executive’s employment shall be extended for one additional year at the end of each year of the term or extended term of this Agreement. For example, if Executive is in compliance with all of his obligations hereunder on September 1, 2003, the term shall be extended until August 31, 2006.

5. **Duties.** Except as otherwise provided, during the period of his employment hereunder and except for illness, specified vacation periods and reasonable leaves of absence, the Executive shall devote his best efforts and full attention and skill during normal working hours to the business and affairs of the Company, as such business and affairs now exist and as they may be hereinafter changed or added to, under and pursuant to the general direction of the Board of Directors of the Company. The Executive will not engage in any other business or activity which, in the reasonable judgment of the Board of Directors of the Company, would conflict or interfere with the performance of the Executive’s duties set forth in this Agreement, whether or not such activity is pursued for gain, profit or other pecuniary advantage; provided, however, that the foregoing shall not prohibit the Executive from (i) pursuing personal investments, and (ii) participating in community affairs, but in each circumstance only to the extent that any such activities described in clause (i) and (ii) would not, in the reasonable judgment of the Board of Directors of the Company, conflict or interfere with the performance of the Executive’s duties set forth in this Agreement or violate the Executive’s covenants in Paragraph 12.

6. **Compensation.** Commencing on September 1, 2002, the Company shall pay to the Executive as compensation for his services the sum of $175,000 per year, payable in accordance with Company policy, or such higher salary as may be from time to time approved by the Board of Directors. In addition, the Executive shall receive such additional compensation and/or bonuses or stock options as may be voted to him at the sole discretion of the Board of Directors.

7. **Expense Reimbursement.** The Company will reimburse the Executive, at least monthly, for all reasonable and necessary expenses incurred by him in carrying out his duties under this Agreement. The Executive shall present to the Chief Financial Officer or Controller each month an itemized account of such expenses in such form as is reasonably required by the Board of Directors. Such expenses shall include attorneys’ fees and disbursements of Executive in connection with any legal proceedings (including, but not limited to, arbitration), whether or not instituted by the Company or Executive, relating to the interpretation or enforcement of any provision of this Agreement; provided, however, that in the case of any such proceeding to which the Company and the Executive are adverse parties, the losing party shall reimburse the prevailing party for all costs
and expenses, including attorneys' fees and disbursements, incurred by the prevailing party in defense or prosecution of any such proceeding. Prior to advancing costs and expenses to the Executive, the Board of Directors shall have the right to obtain an agreement, and to require acceptable security therefor, from Executive requiring him to repay the Company for the same should it be determined that Executive is not entitled to payment of such costs and expenses. Such reimbursement shall be paid every thirty (30) days after the Executive provides copies of invoices from the Executive's counsel to the Company. However, such invoices may be redacted to preserve the attorney-client privilege, client confidentiality or work product.

8. **Group Insurance Coverage.** The Executive, his wife, and those children who qualify will be entitled to participate in the Company's employee group medical and other group insurance programs on the same basis as other executives of the Company.

9. **Medical Examination.** The Executive agrees to submit himself for physical examination on one occasion per year as requested by the Company for the purpose of the Company's obtaining life insurance on the life of the Executive for the benefit of the Company; provided, however, that the Company shall bear the entire cost of such examinations and shall pay all premiums on any key man life insurance obtained for the benefit of the Company as beneficiary.

10. **Vacation Time.** The Executive shall be entitled to take four (4) weeks paid vacation per calendar year. Such vacation may not be taken in any greater than consecutive two (2) week increments. Vacation not used by the Executive during the calendar year will be carried forward up to a maximum of ten (10) weeks accrual going forward.

11. **Benefits Payable on Disability.** If the Executive becomes disabled from properly performing services hereunder by reason of illness or other physical or mental incapacity, the Company shall continue to pay the Executive his then-current salary hereunder for the first twelve (12) months of such continuous disability commencing with the first date of such disability. If the Executive qualifies for coverage during the term of this Agreement, the Company shall purchase and maintain a policy of disability insurance which, after twelve (12) continuous months of disability, will pay up to $12,000 per month of the Executive's salary until the Executive reaches the age of 65. After the first twelve (12) months of disability, the Company has no obligation to supplement or augment disability payments made under any such disability policy or plan or make any other payment in connection with such disability. If the disability insurance policy provides benefits during the first twelve (12) months of disability, the Executive's salary shall be reduced by amounts paid under such policy.

12. **Obligations of Executive During and After Employment.**

(a) The Executive acknowledges that he has agreed to the terms of the Non-Disclosure, Non-Compete and Intellectual Property Assignment and
Agreement attached as Exhibit A of this Agreement to induce the Company to enter into this Agreement.

(b) Because of his employment by the Company, Executive will have access to trade secrets and confidential information about the Company, its business plans, its business accounts, its business opportunities, its expansion plans and its methods of doing business. Executive agrees that for a period of eighteen (18) months after termination of his employment (except if such termination is as a result of termination by Executive with cause under Paragraph 16), he will not, directly or indirectly, compete with the Company or its affiliates by serving as an employer, employee, consultant, principal, or agent, or otherwise directly or indirectly engage in ownership, management, operation, or control, of any business within 500 miles of offices operated by the Company or any subsidiary, on the date of termination, where he is involved, in any manner, in the business of developing or marketing _______________________________________. Ownership shall be defined to exclude ownership of less than five percent of the outstanding equity in a publicly traded entity. This non-compete agreement shall be void and of no further force or effect in the event the Company fails to pay the Executive any amounts due pursuant to Paragraphs 14, 15 or 16, as may be applicable.

(c) Any compensation to be paid to the Executive under Paragraphs 14, 15 or 16 hereof shall be subject to the Executive complying with the non-compete provisions of this Paragraph 12 and the terms of the Non-Disclosure, Non-Compete, Intellectual Property Assignment and License Agreement. In the event the Executive does not so comply, the Company shall be released from any obligations to the Executive under Paragraphs 14, 15 or 16, as may be applicable.

(d) In the event this Agreement is terminated by the Executive with cause pursuant to Paragraph 16, then the Executive shall have the right to terminate the non-compete agreement set forth in this Paragraph 13 by releasing the Company from its obligation to pay the Executive any severance compensation or other form of compensation otherwise payable hereunder. The Executive shall make such election within 30 days of termination with cause by the Executive. In the event this Agreement is terminated by the Executive without cause or by the Company, the non-compete provisions of this Paragraph 12 and as set forth in the Non-Disclosure, Non-Compete, Intellectual Property Assignment and License Agreement cannot be terminated by the Executive.

(e) In the event a court of competent jurisdiction finds any provision of this Paragraph 12 to be so overbroad as to be unenforceable, then such provision shall be reduced in scope by the court, but only to the extent deemed necessary by the court to render the provision reasonable and enforceable, it being the Executive's intention to provide the Company with the broadest protection possible against harmful competition.

(f) Any conflict between the non-compete provisions contained in this Agreement and the Non-Disclosure, Non-Compete and Intellectual Property Assignment and License Agreement will be resolved in favor of the pro-
visions contained in the Non-Disclosure, Non-Compete and Intellectual Property Assignment and License Agreement.

13. **Termination for Cause by the Company.**

(a) Notwithstanding anything herein to the contrary the Company may, without liability, terminate the Executive's employment hereunder for cause at any time upon written notice from the Board of Directors specifying such cause, and thereafter the Company's obligations hereunder shall cease and terminate; provided, however, that the Company shall pay the Executive two (2) weeks pay and that such written notice shall not be delivered until after the Board of Directors shall have given the Executive 10 days' prior written notice specifying the conduct alleged to have constituted such cause and the Executive has failed to cure such conduct, if curable, within five (5) days following receipt of such notice.

(b) Grounds for termination "for cause" are:

(1) A willful and material breach of this Agreement by the Executive during the course of his employment;

(2) Habitual neglect of duty by the Executive;

(3) The Executive's material failure to perform and/or meet objective and measurable financial standards set by the Board of Directors and agreed upon by the Executive in advance;

(4) The commission of any act of financial fraud or financial dishonesty by the Executive;

(5) The commission of a felony and the filing of charges by any local, state or federal prosecutor alleging the Executive committed a felony; or

(6) The commission of a crime that involves moral turpitude that has or could reasonably be expected to have a material adverse effect on the Company, its business or prospects in the reasonable written opinion of the Board of Directors.

14. **Termination by the Company Without Cause.** The Company may terminate the Executive’s services without cause at any time upon sixty (60) days' written notice. In such event, in addition to compensating the Executive during such sixty (60) day notice period, the Company shall be obligated to compensate the Executive with severance pay equal to six months' compensation payable to the Executive in six equal monthly payments commencing on the date of termination and ending six months from such date. Accordingly, in the event the Company terminates this Agreement without cause or chooses not to renew this Agreement upon its expiration, the Executive shall receive (i) an aggregate of eight months' salary from and after the date of the Executive’s receipt of a notice of termination through and including the date that is eight months from the date of termination, and (ii) compensation for any vacation time not taken. All salary calculations shall be based on a 360 day year.
15. **Termination by the Executive Without Cause.** The Executive, without cause, may terminate this Agreement upon 90 days' written notice to the Company. In such event, the Executive shall be required to render the services required under this Agreement during such 90-day period unless otherwise directed by the Board of Directors. Compensation for vacation time not taken by Executive shall be paid to the Executive at the date of termination.

16. **Termination by the Executive For Cause.** The Executive may terminate his employment with the Company at any time, upon 30 days' written notice and opportunity for the Company to remedy any non-compliance, by reason of (i) the Company's material failure to perform its duties pursuant to this Agreement, (ii) any material diminishment in the duties and responsibilities of the Executive as described in Paragraphs 2 and 5 of this Agreement, (iii) any reduction in the Executive's compensation below that set forth in Paragraph 6 hereof, or (iv) Executive's location of employment is moved more than 30 miles from the _________ city limits without the Executive's prior written consent; provided that such termination takes place within 90 days after receipt by Executive of written notice of such relocation. In the event of termination of this Agreement by the Executive for cause, the Executive shall be entitled to his compensation during such thirty (30) days' notice period and a severance allowance equal to six months' salary payable in six equal monthly installments commencing on the date of termination and ending six months from such date.

17. **Termination Upon Death of Executive.** In addition to any other provision relating to termination, this Agreement shall terminate upon the Executive's death. An allowance equal to a total of six months' salary shall be paid in six equal monthly installments to the Executive’s estate during the six month period after the date of death.

18. **Assistance in Litigation.** At the request and expense of the Company (including a reasonable payment based on the Executive’s last per diem earnings with the Company) for the time involved if the Executive is not then in the Company's employ or receiving severance payments from the Company or any of its subsidiaries and upon reasonable notice, the Executive shall, at all times during and for a period of three years after the expiration or termination of this Agreement, furnish such information and assistance to the Company as it may reasonably require in connection with any issue, claim or litigation in which the Company may be involved (other than any such issue, claim or litigation with respect to which the Executive is a party adverse to the Company). During such period, the Executive shall provide such assistance at those times and places as may be reasonably requested by the Company and not unreasonably inconvenient to the Executive. The Executive shall not be required to provide such assistance under this Paragraph 18 for more than three consecutive days or for an aggregate of 15 days or more in any consecutive six-month period.

19. **Arbitration.** Any controversy, dispute or claim arising out of, or relating to, this Agreement and/or its interpretation shall, unless resolved by agreement of the parties, be settled by binding arbitration in _________ in accor-
dance with the Rules of the American Arbitration Association then existing. This Agreement to arbitrate shall be specifically enforceable under the prevailing arbitration law of the State of ________. The award rendered by the arbitrators shall be final and judgment may be entered upon the award in any court of the State of ________ having jurisdiction of the matter.

20. **Executory Rights.** The Company agrees that nothing contained herein is intended or will be deemed to be granted to the Executive in lieu of any rights or privileges to which the Executive may be entitled as an employee of the Company under any retirement, pension, profit sharing, insurance, hospitalization, health or other plan or plans which may now be in effect or which may be adopted hereafter.

21. **Assignment.** The Executive's rights and obligations under this Agreement shall not be transferrable by assignment or otherwise, nor shall the Executive's rights be subject to encumbrance or to the claims of the Company's creditors. Nothing in this Agreement shall prevent the consolidation of the Company with, or its merger into, any other corporation, or the sale by the Company of all or substantially all of its property or assets. In the event of sale, assignment, or other transfer of the Company's business or a substantial part of its assets, or of the Company's merger into or consolidation with another corporation, the rights and benefits of the Company under this Agreement shall be transferred and assigned, with the written consent of the Executive, and all obligations and liability of the Company will thereafter continue.

22. **General Provisions.**

(a) This Agreement, the Non-Disclosure, Non-Compete and Intellectual Property Assignment and License Agreement, Stockholder Agreement and the rights of Executive with respect to the benefits of employment referred to in this Agreement constitute the entire agreement between the parties hereto in respect of the employment of the Executive by the Company and supersede any and all other agreements either oral or in writing between the parties hereto with respect to the employment of the Executive.

(b) Executive shall have no duty to mitigate any payment due him from the Company pursuant to this Agreement and any money earned by the Executive from other sources after his employment with the Company terminates shall not reduce any amount owed to him by the Company pursuant to this Agreement.

(c) The provisions of this Agreement shall be regarded as divisible, and if any of said provisions or any part thereof are declared invalid or unenforceable by a court of competent jurisdiction, the validity and enforceability of the remainder of such provisions or parts thereof and the applicability thereof shall not be affected thereby.

(d) This Agreement may not be amended or modified except by a written instrument executed by Company and Executive.
(e) This Agreement and the rights and obligations hereunder shall be governed by and construed in accordance with the laws of the State of ____________.

23. **Construction.** Throughout this Agreement the singular shall include the plural, and the plural shall include the singular, and the masculine and neuter shall include the feminine, wherever the context so requires.

24. **Text to Control.** The headings of paragraphs and sections are included solely for convenience of reference. If any conflict between any heading and the text of this Agreement exists, the text shall control.

25. **Authority.** The officer executing this agreement on behalf of the Company has been empowered and directed to do so by the Board of Directors of the Company.

FOR THE COMPANY: 
DATED: _____ 2002

COMPANY
By: ______________________

FOR THE EXECUTIVE:
DATED: _____ 2002

EXECUTIVE
By: ______________________
This Stockholders Agreement is dated as of __________, 2002, among Company (the "Company"), Stockholder 1, Stockholder 2 and Stockholder 3 (Stockholder 2 and Stockholder 3 hereinafter collectively, "Founders") (Stockholder 1 and the Founders collectively, the "Stockholders"). All other terms used herein are defined in Annex I hereto.

PREAMBLE

It is deemed to be in the best interests of the Company and the Stockholders that provision be made for the continuity and stability of the business and policies of the Company and to that end, the Company and the Stockholders desire to set forth their agreement with respect to the shares of capital stock and other securities of the Company owned by them.

ACCORDINGLY, in consideration of the mutual covenants and agreements contained in this Agreement, the sufficiency of which is hereby acknowledged, the parties agree as follows:

ARTICLE I

Board of Directors; Other Rights and Obligations

1.1 Board of Directors.

(a) Number of Directors. Each Stockholder shall from time to time take such action, in his capacity as a Shareholder of the Company, including the voting, in person or by proxy, of the Securities of the Company owned or controlled by such Stockholder and entitled to vote, as may be necessary to cause the Company to initially be managed by a Board of Directors consisting of five (5)
directors of whom three (3) directors and two (2) directors, respectively, shall be nominated or designated and elected or appointed by Company and the Founders, respectively.

(b) Removal of Directors. The Board of Directors shall have the exclusive right under this Section 1.1 (b) to require the removal only with cause of any director, except as specified below. In the event that either of the Founders nominated to serve as a director pursuant to Section 1.1 (a) ceases to be employed by the Company, the Board of Directors shall have the right to remove such person as a director without cause.

(c) Vacancies. If a vacancy on the Board exists or is created by reason of the death, removal or resignation of any director, such vacancy shall be filled only in accordance with this Section 1.1 (c), any provision in the By-laws to the contrary notwithstanding. Each of the Stockholders shall vote in person or by proxy all of the Securities of the Company owned or controlled by such Stockholder and entitled to vote at any annual or special meeting of the Shareholders of the Company called for the purpose of voting on the election of directors, or execute a written consent in lieu thereof, and take all such other action as may be necessary to elect, or use his commercially reasonable efforts to cause the remaining directors to elect, a person to fill such vacancy who is nominated by Company or Founders, whichever is entitled to do so, pursuant to Section 1.1(a); provided, however, that each such Stockholder shall not be required to cause the remaining directors to elect a person to fill such vacancy as described in the foregoing clause of this sentence unless the person or persons entitled to fill such vacancy request such Stockholder so act. Notwithstanding the foregoing, if a director is removed from his position as such under the provisions of Section 1.1(b) then, in such event, the remaining directors will take action to fill any such vacancy.

ARTICLE II
Transfers of Securities

2.1. Transfers.

(a) General. The provisions regarding Transfers of Stock contained in this Article II shall apply to all Securities now owned or hereafter acquired by a Stockholder, including Securities acquired by reason of original issuance, dividend, distribution, exchange, conversion and acquisition of outstanding Securities from another Person, and such provisions shall apply to any Securities obtained by a Stockholder upon the exercise, exchange or conversion of any Security, option, warrant or other derivative Security.

(b) Joinder Agreements. No Stockholder shall Transfer any Security to a Person not already a party to this Agreement as a Stockholder unless and until such Person executes and delivers to the Company a joinder agreement (a "Joinder Agreement") in form and substance reasonably acceptable to the Company, pursuant to which such Person will thereupon become a party to, and be bound by and obligated to comply with the terms and provisions of, this
Agreement as a Stockholder hereunder; provided, however, that the foregoing restriction will not apply to sales to the public following an initial public offering of the Company, if any, or to sales pursuant to and consummated in compliance with the provisions of Section 2.3. Any Person who executes a Joinder Agreement shall be designated a Stockholder (as defined in Annex I hereof). No Person who is not a Stockholder who acquires Securities in a Public Sale shall be permitted or required to execute a Joinder Agreement.

(c) **Transfers By Stockholders.** No Stockholder shall, at any time prior to the first anniversary of the date of this Agreement, directly or indirectly through any other Person, solicit or engage in any discussions or negotiations regarding the transfer (other than a Permitted Transfer) to any other Person of, or otherwise Transfer, any Securities of the Company owned or held by such Stockholder or his Permitted Transferees without first obtaining the prior written consent (which shall be subject to approval by the Board of Directors of the Company, in its sole discretion, provided that in the event of such consent, such Transfer shall be subject to the remaining provisions of this Article II. Anything contained in this Section 2.1(c) to the contrary notwithstanding, this Section 2.1 shall not apply to (i) any Transfer of Securities pursuant to or in accordance with Section 2.2 (Co-Sale and Tag-Along Rights), Section 2.3 (Drag-Along Rights), or (ii) any Permitted Transfer.

(d) **Transfers to Competitors.** Except for Transfers pursuant to an Approved Sale in accordance with Section 2.3, no Stockholder shall, without the prior written consent of the Board of Directors, Transfer any Securities of the Company, or any interest therein, if a majority of those members of the Board of Directors who are not Affiliates of such Stockholder (and excluding such Stockholder), after receipt of notice from such Stockholder of a proposed Transfer, in their sole discretion determine in good faith that such Transfer (i) is to any Person who is directly or indirectly engaged in any business or activity that competes with the Company or Company, whether such other engagement shall be as an employee, director, officer, consultant, partner, owner or other participant in any such business or activity, or (ii) would be detrimental to the best interests of the Company.

(e) **Founders’ Assignment and Transfer Rights.** Notwithstanding any of the provisions of Section 2.1(a) through (d), Founders shall have the right to form a legal entity and assign the Business Venture Agreement, this Agreement, and to transfer Founder’s Securities to such legal entity (“Founders’ Entity”). After such an assignment and transfer, Founders’ Entity shall have the same rights and obligations under this Agreement and the Business Venture Agreement as Founders had prior to such assignment. Notwithstanding such assignment and transfer, (i) Founders shall continue to be liable for their respective contributions of capital set forth in the Business Venture Agreement, (ii) Founders shall continue to remain individually obligated to provide services to the Company under their respective Employment Agreements, and (iii) Founders shall continue to be subject to the terms of this Agreement applicable to them. The Founders’ Entity shall be owned only by Founders, subject to the right of Founders to assign and transfer a portion of the ownership interest in Founders’ Entity subject to the condition that
in no event will the Founders beneficial ownership in the Founders' Entity constitute less than 25% of the outstanding Common Stock of the Company, and subject further to the Founders notifying the Company and Company prior to such assignment and transfer of the identity of the proposed transferee or assignee and the amount of ownership interest in the Founders' Entity to be assigned or transferred.

(f) Founders' Transfer of Preferred Shares. Notwithstanding any of the foregoing provisions of Section 2.1, Founders may not transfer or assign the Preferred Shares to any Person other than the Company or Company.

2.2 Co-Sale and Tag-Along Rights.

(a) Subject to Section 2.2(e), if at any time (i) any Stockholder or group of Stockholders acting in concert proposes to Transfer any shares of Stock of the Company in one or a series of related transactions that constitute ten percent (10%) or more of the outstanding shares of such class or series of Stock at the time of such Transfer (taken together with all other transfers in such series of related transactions, if applicable) (each such Stockholder, group of Stockholders acting in concert, being called the “Transferring Stockholder”), then at least fifteen (15) days prior to the closing of such Transfer, the Transferring Stockholder shall deliver a written notice (the “Co-Sale Notice”) to the other Stockholders (the Stockholders receiving a Co-Sale Notice being referred to herein as the “Other Stockholders”) offering the Other Stockholders the option to participate in such proposed Transfer. Such Co-Sale Notice shall specify in reasonable detail the identity of the prospective Transferee and shall include all relevant terms and conditions of the Transfer.

(b) Any Other Stockholder may, within 15 days of the receipt of a Co-Sale Notice, give written notice (a “Tag-Along Notice”) to the Transferring Stockholder stating that such Other Stockholder wishes to participate in such proposed Transfer and specifying the amount of Stock such Other Stockholder desires to include in such proposed Transfer.

(c) If none of the Other Stockholders give the Transferring Stockholder a Tag-Along Notice with respect to the Transfer proposed in the Co-Sale Notice, the Transferring Stockholder may thereafter Transfer the shares specified in the Co-Sale Notice on substantially the same terms and conditions set forth in the Co-Sale Notice. If one or more Other Stockholders give the Transferring Stockholder a timely Tag-Along Notice, then the Transferring Stockholder shall use all reasonable efforts to cause each prospective Transferee to agree to acquire all shares identified in all Tag-Along Notices that are timely given to the Transferring Stockholder, upon the same terms and conditions as are applicable to the Transferring Stockholder's shares. If such prospective Transferee is unwilling or unable to acquire all shares proposed to be included in such sale upon such terms, then the Transferring Stockholder must allocate the maximum number of shares that each prospective Transferee is willing to purchase among the Transferring Stockholder and the Other Stockholders giving timely Tag-Along Notices in proportion to such Other Stockholders' (including the Transferring Stockholder's) Proportionate Percentages or such Transferring Stockholder will not be permitted to consummate the proposed Transfer.
Tag-Along and Drag-Along Rights in Company Sale or IPO.

(1) Subject to Section 2.2 (e), in the event of a (i) Sale of Company, including a proposed sale in which the purchaser wishes to acquire all or substantially all of the common shares and common share equivalents of Company, and therefore the Founders sale of their Converted Shares is required, or (ii) IPO of Company, notice of the proposed Sale of Company or IPO shall be given to Founders in writing (the “Company Sale Notice” or the “Company IPO Notice”) as soon as practicable, but not later than 30 days before the transaction is schedule to close. If the purchaser in a proposed sale of Company wishes to acquire all or substantially all of Company’s common shares and equivalents, Company shall so inform Founders in the Company Sale Notice that Founders’ participation in the proposed sale will be required (the “Drag-Along Company Sale Notice”). If the participation of the Founders in the proposed Sale of Company is not required, then Founders shall notify Company within 10 days of the date of the Company Sale Notice if Founders wish to have any of their Converted Shares included in the Sale of Company (a “Tag-Along Company Sale Notice”).

(2) After receipt of the Tag-Along Company Sale Notice, Company shall use its best efforts to ensure that Founders’ Converted Shares, in proportion to Founders’ ownership of Company shares after conversion, are sold to the sellers as part of the Company Sale on substantially the same terms and conditions applicable to other selling Company shareholders.

(3) After receipt of the Drag-Along Company Sale Notice, Company shall include the Founders’ Converted Shares, in proportion to Founders’ ownership of Company shares after conversion, in the Sale of Company transaction on substantially the same terms and conditions applicable to other selling Company shareholders. Founders shall provide all reasonable cooperation as may be necessary to assist Company in the closing of a Sale of Company including, but not limited to, the execution of all necessary documents, certifies, stock powers, and similar documents and the delivery of the same to the purchaser of Company.

(e) Anything contained in this Section 2.2 to the contrary notwith-standing, (i) this Section 2.2 shall not apply to (A) any Permitted Transfer, (B) a Stockholder's Transfer of Securities to a Stockholder exercising its right to purchase Offered Securities under Section 2.1(c), or (C) Transfers pursuant to Article II hereof.

2.3 Drag-Along Rights.

(a) If at any time the required Stockholders shall approve a Sale of the Company (an “Approved Sale”), then, subject to Section 2.3(b) below: (i) all Stockholders shall consent to and raise no objections against the Approved Sale and shall cause their designees on the Board, if any, to take all necessary corporate action to approve such Approved Sale; (ii) if the Approved Sale is structured in whole or part as a merger or consolidation, or a sale of all or substantially all assets, each Stockholder shall waive any dissenters rights, appraisal rights or similar rights in connection with such merger, consolidation or asset sale; (iii) if the Approved Sale is structured in whole or part as a sale of
Securities of the Company, the Stockholders shall agree to sell their Shares on the terms and conditions approved by and applicable to the them; and (iv) the Stockholders shall take all necessary and desirable actions in connection with the consummation of the Approved Sale including the execution of such agreements and such instruments and other actions reasonably necessary to provide the representations, warranties, indemnities, covenants, conditions, non-compete agreements, escrow agreements and other provisions and agreements relating to such Approved Sale, and effectuate the allocation and distribution of the aggregate consideration upon the Approved Sale as set forth in Section 2.3(b) below. The Stockholders shall be permitted to sell their Shares pursuant to an Approved Sale without complying with the provisions of Sections 2.1 and 2.2 of this Agreement.

(b) The obligations of the Stockholders pursuant to this Section 2.3 are subject to the satisfaction of the following conditions:

(i) upon the consummation of the Approved Sale, all of the Stockholders shall receive the same proportion of the aggregate consideration from such Approved Sale that such holder would have received if such aggregate consideration had been distributed by the Company in complete liquidation pursuant to the rights and preferences set forth in the Charter as in effect immediately prior to such Approved Sale (without giving effect to any preferences and orders of priority of the Preferred Stock, of which there shall be none except the right to vote at meetings of Stockholders on an “as if” converted basis) determined by taking into account the exercise or cashing-out of Common Stock Equivalents pursuant to clause (iii) below, as applicable; 

(ii) if any Stockholder is given an option as to the form and amount of consideration to be received, all Stockholders will be given the same option;

(iii) all holders of then-currently exercisable Common Stock Equivalents will be given an opportunity to either (A) exercise their rights to acquire the Stock underlying such Common Stock Equivalents prior to the consummation of the Approved Sale (but only to the extent such Common Stock Equivalents are then vested or exercisable or would be vested or exercisable pursuant to their respective terms) and participate in such sale as Stockholders or upon the consummation of the Approved Sale, receive in exchange for such Common Stock Equivalents consideration equal to the amount determined by multiplying (1) the amount of consideration per share of Stock (of the same class as that for which the Common Stock Equivalent is then exercisable) received by the holders of such class of Stock in connection with the Approved Sale (after taking into account any dilutive effect that would have resulted had such holder participated in such sale as a Stockholder) less the exercise price per Common Stock Equivalent by (2) the number of Common Stock Equivalents (but only to the extent such Common Stock Equivalents are then vested or exercisable); and

(iv) no Stockholder shall be obligated to make any out-of-pocket expenditure prior to the consummation of the Approved Sale (excluding
modest expenditures for its own postage, copies, etc., and the fees and expenses of its own counsel retained by it), and no Stockholder shall be obligated to pay more than its or his pro rata share (based upon the amount of consideration received for or with respect to their shares of Stock and vested Common Stock Equivalents) of reasonable expenses incurred in connection with such Approved Sale to the extent such costs are incurred for the benefit of all Stockholders and are not otherwise paid by the Company or the acquiring party (including the costs of one counsel chosen by the Stockholders) (costs incurred by or on behalf of a Stockholder for its or his sole benefit will not be considered costs of the transaction hereunder);

(v) no Stockholder shall be required to execute any non-compete agreement which is more restrictive in time or scope than any non-compete covenant from such Stockholder to the Company in effect prior to such Approved Sale or incur any personal liability for indemnification in connection with an Approved Sale without his express written consent (provided that the foregoing shall not prohibit the Company from placing in escrow (or a similar withholding) a portion of the consideration to be paid in connection with such Approved Sale if such amount is withheld from each Stockholder in equal proportion to the consideration received by such Stockholder and each such Stockholder is entitled to receive a similar proportionate share of the such amount remaining upon termination of the applicable escrow or indemnity period); and

(vi) no Stockholder shall be entitled to receive any payment in such Approved Sale that is in addition to its share of the consideration in such Approved Sale to which it is entitled hereunder unless any such additional payment is shared by all Stockholders pro rata based on their respective Proportionate Percentages (excluding, however, compensation for services rendered to the Company).

2.4 Preemptive Rights.

(a) Except in the case of Excluded Securities, the Company shall not, at any time prior to the consummation of an initial public offering of the Company, issue, sell or exchange, agree to issue, sell or exchange, or reserve or set aside for issuance, sale or exchange (i) any equity Security of the Company, (ii) any debt Security of the Company which by its terms is convertible into or exchangeable for any equity Security of the Company, or (iii) any option, warrant or other right to subscribe for, purchase or otherwise acquire any equity Security of the Company or any debt Security of the Company referred to in clause (ii) above, unless in each case the Company shall have first offered (the “Preemptive Offer”) to sell such Securities (the “Preemptive Offer Securities”) to the Stockholders by delivery to such Stockholders of written notice of such offer (the “Preemptive Offer Notice”) stating that the Company proposes to sell such Preemptive Offer Securities, the number or amount of the Preemptive Offer Securities proposed to be sold, the proposed purchase price therefor and any other terms and conditions of such offer. The Preemptive Offer shall by its terms remain open and irrevocable for a period of 15 days from the date it is delivered by the
Company or such longer period as may be determined by the Company (the “Preemptive Offer Period”).

(b) Each Stockholder shall have the option, exercisable at any time during the Preemptive Offer Period by delivering written notice to the Company (a “Preemptive Offer Acceptance Notice”), to subscribe for (i) the number or amount of such Preemptive Offer Securities up to the total number or amount of Preemptive Offer Securities proposed to be issued as specified in its Preemptive Offer Acceptance Notice. Such Stockholder shall automatically be reserved sufficient shares equal to its Proportionate Percentage. Any Preemptive Offer Securities not subscribed for by a Stockholder shall be deemed to be re-offered to and accepted by the Stockholders (the “Participating Shareholders”) exercising their options specified in clause (ii) of the immediately preceding sentence with respect to the lesser of (A) the amount specified in their respective Preemptive Offer Acceptance Notices, and (B) an amount equal to their respective Proportionate Percentages with respect to such deemed offer. Such deemed offer and acceptance procedures described in the immediately preceding sentence shall take place on one occasion only and, if not exercised by any Stockholder on such one occasion, shall be deemed extinguished. The Company shall notify each Participating Stockholder within five days following the expiration of the Preemptive Offer Period of the number or amount of Preemptive Offer Securities which such Participating Stockholder has subscribed to purchase. Anything contained herein to the contrary notwithstanding, the Company may condition the consummation of the issuance and sale of Preemptive Offer Securities pursuant to a Preemptive Offer on the receipt by the Company of an amount of gross proceeds, or on the satisfaction of any other conditions, determined by the Company in its sole discretion, and in such case may abandon any such proposed sale if such will not result in such gross proceeds to the Company, or if any of such other conditions are not satisfied.

(c) If Preemptive Offer Acceptance Notices are not given by the Stockholders for all the Preemptive Offer Securities, the Company shall have 180 days from the expiration of the Preemptive Offer Period to sell all or any part of such Preemptive Offer Securities as to which Preemptive Offer Acceptance Notices have not been given by the Stockholders (the “Refused Securities”) to any other Persons, but only upon terms and conditions in all respects, including unit price, dividends and interest rates, which are no more favorable, in the aggregate, to such other Persons or less favorable to the Company than those set forth in the Preemptive Offer. Upon the closing, which shall include full payment to the Company, of the sale to such other Persons of all the Refused Securities, the Stockholders shall purchase from the Company, and the Company shall sell to the Stockholders, the Preemptive Offer Securities in respect of which Preemptive Offer Acceptance Notices were delivered by the Stockholders, at the terms specified in the Preemptive Offer.

(d) The rights under this Section 2.4 shall not apply to the following Securities (the “Excluded Securities”):
(i) any warrants issued to one or more third party lenders (who are not Affiliates of the Company) providing debt financing to the Company and Securities issued upon the exercise, conversion or exchange of such warrants in accordance with their stated terms;

(ii) any Securities issued to one or more third party sellers and other Persons (who are not Affiliates of the Company) by the Company as consideration in an Acquisition by the Company;

(iii) any Securities issued by the Company in an underwritten Public Offering;

(iv) Securities issued upon the exercise or conversion of Stock Equivalents issued in compliance with (or not otherwise in violation of) this Section 2.4;

(v) shares of Stock issued in a Stock Recapitalization;

(vi) Securities issued upon conversion of other shares of capital stock or Convertible Securities of the Company pursuant to the Charter or resolution of the Board of Directors; and

(vii) Securities issued to Persons (who are not Affiliates of the Company) entering into “corporate partnering,” “strategic investment” or other similar types of transactions or relationships with the Company (the characterization of such transactions or relationships to be in the sole discretion of the Board of Directors), in which the granting of equity or equity rights constitutes an aspect of such transaction or relationship.

2.5 Extinguishment of Preemptive Rights.

Notwithstanding any other language to the contrary set forth elsewhere herein, the Company shall have no obligation to provide a Preemptive Offer Notice to any Stockholder if at the time the Company is required to provide such notice by the terms of Section 2.4 hereof the Stockholder is no longer employed by the Company. Likewise, Preemptive Offer Acceptance Notices shall only be effective if tendered by the Stockholder when the Stockholder is employed by the Company. Any preemptive rights described in Section 2.4 hereof shall be extinguished without further action of the parties hereto upon a Stockholder ceasing to be employed by the Company.

ARTICLE III

Repurchase of Stock from Stockholders

3.1 Repurchase Options Upon Stockholder's Death.

(a) In the event that the Representative of a deceased Stockholder proposes to make any Transfer as a distribution of Stock pursuant to will or intestate succession, such Representative shall give notice thereof to the Company (the “Estate Distribution Notice”). The Company may also on its own
initiative, after the death of a deceased Stockholder, give the Representative notice that it wishes to commence the procedures under this Section 3.1, which notice shall also be deemed an Estate Distribution Notice. Promptly (and in no event later than 10 days) after receipt of such Estate Distribution Notice by the Company or the giving of such Estate Distribution to the Representative, the Company shall mail a copy thereof to each Stockholder (the date of such mailing by the Company to the Stockholders being referred to herein as the “Estate Distribution Notice Date”).

(b) Upon receipt or delivery of an Estate Distribution Notice as hereinabove provided, the Company shall have the option (the “Estate Repurchase Option”), exercisable by giving written notice thereof (the “Estate Repurchase Notice”) to the Representative within 60 days after the Estate Distribution Notice Date, to purchase all or any part of the Shares held by such deceased Stockholder or his estate or Representative at a purchase price that shall be calculated according to the Purchase Price Formula and that shall be paid in cash at the closing of such sale or on such terms as the Company and the Representative may otherwise agree.

(c) If for any reason the Company does not elect to purchase all of the Shares pursuant to the Estate Repurchase Option, the Company shall assign the portion of the Estate Repurchase Option it has determined not to exercise to the Stockholders. Upon such assignment, any of the Stockholders other than the Permitted Transferees of the deceased Stockholder (the “Section 3.1 Eligible Stockholders”) may at its option exercise the Estate Repurchase Option for the Shares that the Company has not elected to purchase (the “Section 3.1 Available Shares”). As soon as practicable after the Company has determined that there will be Section 3.1 Available Shares, but in any event within 60 days after the Estate Distribution Notice Date, the Company shall deliver written notice (the “Stockholders’ Estate Repurchase Notice”) to the Section 3.1 Eligible Stockholders, setting forth the number of Section 3.1 Available Shares and the price thereof. Each Section 3.1 Eligible Stockholder may elect to purchase any number of Section 3.1 Available Shares by delivering written notice to the Company within 30 days after receipt of the Stockholders’ Estate Repurchase Notice from the Company. The Section 3.1 Eligible Stockholders electing to repurchase Shares pursuant to this paragraph (c) are referred to collectively herein as the “Section 3.1 Repurchasing Stockholders.” As soon as practicable, and in any event within 5 days after the expiration of the 30-day period set forth above, the Company shall notify (the “Supplemental Repurchase Notice”) the Representative as to the number of Shares being purchased from such Representative by the Company and the Section 3.1 Repurchasing Stockholders. At the time the Company delivers the Supplemental Estate Repurchase Notice to the Representative, each of the Section 3.1 Repurchasing Stockholders shall also receive written notice from the Company setting forth the number of Section 3.1 Available Shares it is entitled to purchase, the aggregate purchase price (if known) and the time and place of the closing of the transaction.
(d) If the number of Section 3.1 Available Shares which the Section 3.1 Eligible Stockholders have elected to purchase exceeds the number of Section 3.1 Available Shares, then (unless the affected parties agree to another allocation amongst themselves) the number of such Section 3.1 Available Shares which the Section 3.1 Eligible Stockholders shall purchase will be proportionate among Section 3.1 Repurchasing Stockholders based on their respective Proportionate Percentages at the time of delivery of the Supplemental Estate Repurchase Notice (but not in excess of the number of Section 3.1 Available Shares each of them has elected to purchase, with any such excess being reallocated among the remaining holders in the same manner).

(e) If the Estate Repurchase Option is duly exercised by the Company and/or Section 3.1 Repurchasing Stockholders for all of the Shares that are subject to the Estate Repurchase Option, then the closing shall occur at the principal offices of the Company at 10:00 a.m. on the tenth Business Day after such exercise, or at such other place, time and date as the Company, the Section 3.1 Repurchasing Stockholders and the Representative may agree. At such closing, the Representative shall deliver to the Company and to each Section 3.1 Repurchasing Stockholder the certificates for the Shares being sold, duly endorsed and with all appropriate assurances, free and clear of all liens, encumbrances and adverse claims and with any transfer taxes paid, and, against receipt thereof, (A) the Company shall pay to the Representative in cash or equivalent the purchase price therefor and (B) each Section 3.1 Repurchasing Stockholder shall pay to the Representative in cash the purchase price therefor, in each case calculated in accordance with the Purchase Price Formula.

(f) If and to the extent the Company and the Section 3.1 Eligible Stockholders do not duly exercise the Estate Repurchase Option for all of the Shares that are subject to the Estate Repurchase Option within sixty (60) days after the Estate Distribution Notice Date (or, having exercised such option, the Company and the Section 3.1 Eligible Stockholders rescind such exercise as herein permitted), then the Representative may thereafter distribute the Shares that were subject to the Estate Repurchase Option to the beneficiaries of the deceased Stockholder's estate or otherwise, provided that with respect to such Shares so distributed such Shares shall be subject to the voting proxy pursuant to Section 3.4 and each such Transferee shall have complied with the provisions of Section 2.1(b).

3.2 Upon Event of Option.

(a) In the event of an occurrence of an Event of Option as to any Stockholder, such Stockholder (the "Affected Stockholder") shall give notice thereof to the Company (the "Event of Option Notice"). The Company may also on its own initiative, after the occurrence of an Event of Option as to any Stockholder, give the Affected Stockholder notice that it wishes to commence the procedures under this Section 3.2, which notice shall also be deemed an Event of Option Notice. Promptly (and in no event later than 10 days) after receipt of such Event of Option Notice by the Company or the giving of such Event of Option Notice to the Affected Stockholder, the Company shall mail a copy thereof to each Stockholder (the date of
such mailing by the Company to the Stockholders being referred to herein as the “Event of Option Notice Date”).

(b) Upon receipt or delivery of an Event of Option Notice as hereinabove provided, the Company shall have the option (the “Event of Option Repurchase Option”), exercisable by giving written notice thereof (the “Event of Option Repurchase Notice”) to the Affected Stockholder within 60 days after the Event of Option Notice Date, to purchase all or any part of the Shares held by such Stockholder at a purchase price determined in accordance with the Purchase Price Formula.

The purchase price arrived at through the application of the Purchase Price Formula shall be payable at the election of the Company or its assignee (A) in cash in full at the closing of such sale, or (B) upon other terms, if any, as the Company and the Affected Stockholder may otherwise agree.

(c) If for any reason the Company does not elect to purchase all of the Shares pursuant to the Event of Option Repurchase Option, the Company shall assign the portion of the Event of Option Repurchase Option they have determined not to exercise to the Stockholders other than the Affected Stockholders. Upon such assignment, any of the Stockholders other than Permitted Transferees of the Affected Stockholder (the “Section 3.2 Eligible Stockholders”) may at its option exercise the Event of Option Repurchase Option for the Shares the Company have not elected to purchase (the “Section 3.2 Available Shares”). As soon as practicable after the Company has determined that there will be Section 3.2 Available Shares, but in any event within 60 days after the Event of Option Notice Date, the Company shall deliver written notice (the “Stockholders’ Repurchase Notice”) to the Section 3.2 Eligible Stockholders, setting forth the number of Section 3.2 Available Shares and the price thereof. The Section 3.2 Eligible Stockholders may elect to purchase any number of Section 3.2 Available Shares by delivering written notice to the Company within 30 days after receipt of the Stockholders’ Repurchase Notice from the Company. (The Section 3.2 Eligible Stockholders electing to repurchase Section 3.2 Available Shares pursuant to this paragraph (c) are referred to collectively herein as the “Section 3.2 Repurchasing Stockholders.”) As soon as practicable, and in any event within 5 days after the expiration of the 30-day period set forth above, the Company shall notify (the “Supplemental Repurchase Notice”) the Affected Stockholder as to the number of Shares being purchased from such Stockholder by the Section 3.2 Repurchasing Stockholders. At the time the Company delivers the Supplemental Repurchase Notice to the Affected Stockholder, each of the Section 3.2 Repurchasing Stockholders shall also receive written notice from the Company setting forth the number of Section 3.2 Available Shares it is entitled to purchase the aggregate purchase price (if known) and the time and place of the closing of the transaction.

(d) If the number of Section 3.2 Available Shares which the Section 3.2 Eligible Stockholders have elected to purchase exceeds the number of Section 3.2 Available Shares allocated to such Section 3.2 Eligible Stockholders, then (unless the affected parties agree to another allocation
amongst themselves) the number of such Section 5.2 Available Shares which the Section 3.2 Eligible Stockholders shall purchase will be pro rated among such 2.2 Eligible Stockholders based on the number of Shares held by each such Stockholder at the time of delivery of the Supplemental Repurchase Notice (but not in excess of the number of Section 3.2 Available Shares each of them has elected to purchase, with any such excess being reallocated among the remaining holders in the same manner).

(e) If the Event of Option Repurchase Option is duly exercised by the Company or the Section 3.2 Eligible Repurchasing Stockholders for all of the Shares subject to the Event of Option Repurchase Option, then the closing shall occur at the principal offices of the Company at 10:00 a.m. on the tenth Business Day after the date of such exercise, or at such other place, time and date as the Company, the Section 3.2 Eligible Repurchasing Stockholders and the Affected Stockholder may agree. At such closing, the Affected Stockholder shall deliver to the Company and to each Section 3.2 Eligible Repurchasing Stockholder the certificates for the Shares being sold, duly endorsed and with all appropriate assurances, free and clear of all liens, encumbrances and adverse claims and with any transfer taxes paid, and, against receipt thereof, (A) the Company and/or (B) each Section 3.2 Eligible Repurchasing Stockholder shall pay to the Affected Stockholder in cash the purchase price therefor calculated in accordance with the Purchase Price Formula.

(f) If and to the extent the Company and the Section 3.2 Eligible Stockholders do not duly exercise the Event of Option Repurchase Option for all of the Shares subject to the Event of Option Repurchase Option within sixty (60) days after the Event of Option Notice Date (or, having exercised such option, the Company and the Section 3.2 Eligible Stockholders rescind such exercise as herein permitted), then the Affected Stockholder may thereafter distribute the Shares that were subject to such Event of Option Repurchase Option, provided that with respect to such Shares so distributed such Shares shall be subject to the voting proxy pursuant to Section 3.4 and each such Transferee shall have complied with the provisions of Section 2.1(b).

3.3 Repurchase Rights Upon a Termination of Employment.

(a) If a Stockholder's employment with the Company is terminated by such Stockholder (other than as a result of the death or disability of such Stockholder) at any time (a "Voluntary Termination"), such Stockholder shall give notice thereof to the Company (the "Termination Notice"). The Company may also on its own initiative, after the Company's termination at any time of such Stockholder's employment with the Company for Cause (a "Termination for Cause") or without Cause (a "Termination Without Cause") or due to Disability (a "Disability Termination"), give the Stockholder notice that it wishes to commence the procedures under this Section 3.3, which notice shall also be deemed a Termination Notice. Promptly (and in no event later than 10 days) after receipt of such Termination Notice by the Company or the giving of such Termination Notice to the Stockholder, the Company shall mail a copy thereof to each Stockholder (the date of such mailing by the Company to the Stockholders being referred to herein as the "Termination Notice Date").
(b) Upon receipt or delivery of a Termination Notice as hereinabove provided, first the Company and, if the Company shall not exercise such option, then the Stockholders other than the Stockholder whose employment with the Company has terminated (the "Section 3.3 Eligible Stockholders") shall have the option (the "Termination Repurchase Option"), exercisable by giving written notice thereof which shall state the purchase price to be paid for such Shares (the "Termination Repurchase Notice") to the terminated Stockholder within 60 days after the Termination Notice Date, which purchase price shall be calculated in accordance with the Purchase Price Formula and shall be payable within 90 days of the Termination Notice Date except as otherwise described below.

The purchase price shall be payable at the election of the Company or the Section 3.3 Eligible Stockholders, as the case may be, (A) in cash in full at the closing of such sale, or (B) in the event of a Voluntary Termination or a Termination for Cause only, in four or fewer equal annual installments (as may be determined in the sole discretion of the Company or the Section 3.3 Eligible Stockholders) that shall be evidenced by a promissory note providing for payments at the closing of such sale and on each anniversary thereof until paid in full, together with interest at a rate per annum equal to the prime rate as published from time to time in the Wall Street Journal measured as of December 31 of each year while all or a portion of the purchase price remains outstanding, or (C) upon such other terms, if any, as the Company or the Section 3.3 Eligible Stockholders and the terminated Stockholder may otherwise agree.

(c) In the event of a repurchase of any or all of the Shares from a terminated Stockholder pursuant to this Section 3.3 at a Market Price determined by the Board pursuant to clause (iii) of the definition of such term in Annex I attached hereto, the terminated Stockholder or his Representative (as the case may be) shall have the right to contest the Board’s determination thereof by giving written notice thereof to the Company at any time within 20 days after the Company’s delivery of the Termination Repurchase Notice to the terminated Stockholder or his Representative. The Company and the terminated Stockholder or his Representative shall for a period of 20 days thereafter attempt in good faith to resolve any disagreement between them as to the Market Price of all or any portion of the Shares subject to repurchase at the Market Price in accordance with the Purchase Price Formula. If the Company and the terminated Stockholder or his Representative cannot reach agreement on the Market Price of such Shares within such 20-day period, the Market Price shall be determined by an investment banking firm of national recognition, which firm shall be reasonably acceptable to the Company and the terminated Stockholder or his Representative. If the Company and the terminated Stockholder or his Representative are unable to agree upon an acceptable investment banking firm within ten (10) days after the date either party proposed that one be selected, the investment banking firm will be selected by an arbitrator located in the City of __________, selected by the American Arbitration Association (or if such organization ceases to exist, the arbitrator shall be chosen by a court of competent jurisdiction). The arbitrator shall select the investment banking firm (within ten (10) days of his appointment) from a list, jointly
prepared by the Company and the terminated Stockholder or his Representative, of not more than six investment banking firms of national standing in the United States, of which no more than three may be named by the Company and no more than three may be named by the terminated Stockholder or his Representative. The arbitrator may consider, within the ten-day period allotted, arguments from the parties regarding which investment banking firm to choose, but the selection by the arbitrator shall be made in its sole discretion from the list of six. The Company and the terminated Stockholder or his Representative shall submit to the investment banking firm their respective calculations of the Market Price of such Shares, and any supporting arguments and other data as they may desire, within 10 days of the appointment of the investment banking firm, and the investment banking firm shall as soon as practicable thereafter make its own calculation of the Market Price thereof. The final Market Price for purposes hereof shall be that Market Price submitted by the Company or the terminated Stockholder or his Representative that is closest to the Market Price determined by the investment banking firm. The final determination of the Market Price of such Shares pursuant to the immediately preceding sentence shall be final and binding upon the parties. The fees and expenses of the investment banking firm and arbitrator (if any) used to determine the Market Price of such Shares shall be paid by the party whose Market Price submitted to the investment banking firm was not determined to be closest to the final Market Price. If required by any such investment banking firm or arbitrator, the Company and the terminated Stockholder or his Representative shall execute a retainer and engagement letter containing reasonable terms and conditions, including, without limitation, customary provisions concerning the rights of indemnification and contribution by the Company and the terminated Stockholder or his Representative in favor of such investment banking firm or arbitrator and its officers, directors, partners, employees, agents and Affiliates.

(d) If for any reason the Company does not elect to purchase all of the Eligible Shares pursuant to the Termination Repurchase Option, the Company shall assign the portion of the Termination Repurchase Option it has determined not to exercise to the Section 3.3 Eligible Stockholders. Upon such assignment to the Section 3.3 Eligible Stockholders, the Section 3.3 Eligible Stockholders, may at his or its option exercise the Termination Repurchase Option for the Shares that the Company has not elected to purchase (the "Section 3.3 Available Shares"). As soon as practicable after the Company has determined that there will be Section 3.3 Available Shares, but in any event within 60 days after the Termination Notice Date, the Company shall deliver written notice (the "Stockholders' Termination Repurchase Notice") to the Section 3.3 Eligible Stockholders, setting forth the number of Section 3.3 Available Shares and the price thereof. Each Section 3.3 Eligible Stockholder may elect to purchase any number of Section 3.3 Available Shares by delivering written notice to the Company within 30 days after receipt of the Stockholders' Termination Repurchase Notice from the Company. (The Section 3.3 Eligible Stockholders electing to repurchase Shares pursuant to this paragraph (c) are referred to collectively herein as the "Section 3.3 Repurchasing Stockholders.") As soon as practicable, and in any event within
5 days after the expiration of the 30-day period set forth above, the Company shall notify (the "Supplemental Termination Repurchase Notice") the Stockholder as to the number of Shares being purchased from such Stockholder by the Company and the Section 3.3 Repurchasing Stockholders. At the time the Company delivers the Supplemental Termination Repurchase Notice to the Stockholder, each of the Section 3.3 Repurchasing Stockholders shall also receive written notice from the Company setting forth the number of Section 3.3 Available Shares it is entitled to purchase, the aggregate purchase price (if known) and the time and place of the closing of the transaction.

(e) If the number of Section 3.3 Available Shares which the Section 3.3 Eligible Stockholders have elected to purchase exceeds the number of Section 3.3 Available Shares, then (unless the affected parties agree to another allocation amongst themselves the number of such Section 3.3 Available Shares which the Section 3.3 Eligible Stockholders shall purchase will be pro rated among such Section 3.3 Repurchasing Stockholders based on the number of Shares held by each such Stockholder at the time of delivery of the Supplemental Termination Repurchase Notice (but not in excess of the number of Section 3.3 Available Shares each of them has elected to purchase, with any such excess being reallocated among the remaining holders in the same manner).

(f) If the Termination Repurchase Option is duly exercised by the Company and/or the Section 3.3 Repurchasing Stockholders, then the closing shall occur at the principal office of the Company at 10:00 a.m. on the tenth Business Day after the date of such exercise (or, if later, after the date the Market Price of the Shares to be purchased is determined pursuant to Section 3.3(c), if applicable), or at such other place, time and date as the Company, the Section 3.3 Repurchasing Stockholders and the Stockholder may agree. At such closing, the Stockholder shall deliver to the Company and to each Section 3.3 Stockholder the certificates for the Shares being sold, duly endorsed and with all appropriate assurances, free and clear of all liens, encumbrances and adverse claims and with any transfer taxes paid, and, against receipt thereof (A) the Company or (B) each Section 3.3 Repurchasing Stockholder shall pay to the Stockholder in cash or equivalent the purchase price therefor (or, if such purchase price is payable by the Company in installments, the amount due at such closing and shall deliver a subordinated, unsecured promissory note for the balance payable as provided Section 3.3(b).

(g) If and to the extent the Company and the Section 3.3 Eligible Stockholders do not duly exercise the Termination Repurchase Option within sixty (60) days after the Termination Notice Date (or, having exercised such option, the Company and the Section 3.3 Eligible Stockholders rescind such exercise as herein permitted), then the Stockholder shall continue to be bound by and subject to this Agreement as a Stockholder with respect to the Shares held by him, notwithstanding the termination of the Stockholder's employment with the Company.

3.4 Purchase Rights Limited.

Each of the Company's and the Stockholders' respective rights to purchase Shares pursuant to any provision of this Article III is an option and not an obligation of such Person, and any exercise of such option may be rescinded at any
time prior to the date fixed for the closing of any such purchase for any reason by the party having the right to exercise such option.

(a) Each Permitted Transferee of a Stockholder hereby grants to the Board of Directors of the Company an irrevocable proxy to vote such Stock at any and all meetings of the stockholders of the Company and to execute and deliver any and all written consents in lieu thereof and otherwise exercise any and all consensual rights with respect to such Stock to the same extent and with the same effect as such Stockholder could do under this Agreement, under any applicable law or otherwise. Each such Permitted Transferee acknowledges and agrees that the proxy granted by him under this Section 3.4(a) is coupled with an interest and may not be revoked. All Stock subject to a proxy granted hereunder that becomes effective pursuant to the terms hereof and that is to be voted by a proxy holder or holders pursuant to this Section 3.4(a) shall be voted by such proxy holder or holders in the manner provided in the By-laws of the Company as in effect at the time in question.

(b) Each Stockholder (and his or her Permitted Transferees) hereby grants to the Board of Directors of the Company, effective only upon, but at all times after, any Transfer of Stock of the Company owned by such Stockholder (and his Permitted Transferees) upon or in connection with the death or marital divorce, annulment or separation of such Stockholder an irrevocable proxy to vote such Stock at any and all meetings of the Shareholders of the Company and to execute and deliver any and all written consents in lieu thereof and otherwise exercise any and all consensual rights with respect to such Stock to the same extent and with the same effect as such Stockholder (or any such Permitted Transferee) could do under this Agreement, under any applicable law or otherwise. Each Stockholder (and his or her Permitted Transferees) acknowledges and agrees that the proxy granted by him or her under this Section 3.4 is coupled with an interest and may not be revoked. All Stock subject to a proxy granted hereunder that becomes effective pursuant to the terms hereof and that is to be voted by a proxy holder or holders pursuant to this Section 3.4 shall be voted by such proxy holder or holders in the manner provided in the By-laws of the Company as in effect at the time in question.

ARTICLE IV

Securities Law Compliance; Legends

4.1 Restriction on Transfer.

In addition to any other restrictions on the Transfer of any Securities contained in this Agreement, the Stockholders shall not Transfer any Restricted Securities except in compliance with the conditions specified in this Article IV.

4.2 Restrictive Legends.

Each certificate for the Restricted Securities shall (unless otherwise provided by the provisions of Section 4.4) be stamped or otherwise imprinted with a legend in substantially the following terms:
"THE SECURITIES REPRESENTED BY THIS CERTIFICATE HAVE BEEN ACQUIRED FOR INVESTMENT AND HAVE NOT BEEN REGISTERED UNDER THE UNITED STATES SECURITIES ACT OF 1933 OR ANY STATE SECURITIES OR BLUE SKY LAWS. THESE SECURITIES MAY NOT BE SOLD OR TRANSFERRED IN THE ABSENCE OF SUCH REGISTRATION OR AN EXEMPTION THEREFROM UNDER SAID ACT OR LAWS."

4.3. Additional Legend.

Each certificate evidencing Shares and each certificate issued in exchange for or upon the Transfer of any Shares (if such shares remain Shares as defined herein after such Transfer) shall be stamped or otherwise imprinted with a legend in substantially the following form:

"THE SECURITIES REPRESENTED BY THIS CERTIFICATE ARE SUBJECT TO A STOCKHOLDERS AGREEMENT DATED AS OF __________, 2002, AMONG THE ISSUER OF SUCH SECURITIES (THE "COMPANY") AND CERTAIN OF THE COMPANY'S STOCKHOLDERS. THE TERMS OF SUCH STOCKHOLDERS AGREEMENT INCLUDE, AMONG OTHER THINGS, VOTING AGREEMENTS, REPURCHASE AGREEMENTS AND RESTRICTIONS ON TRANSFERS. A COPY OF SUCH STOCKHOLDERS AGREEMENT WILL BE FURNISHED WITHOUT CHARGE BY THE COMPANY TO THE HOLDER HEREOF UPON WRITTEN REQUEST."

The Company shall imprint such legends on certificates evidencing shares outstanding prior to the date hereof. The legend set forth above shall be removed from the certificates evidencing Securities which cease to be Shares in accordance with the terms of this Agreement.

4.4 Notice of Transfer.

The holders of any Restricted Securities, by its acceptance or purchase thereof, agrees, prior to any Transfer of any such Restricted Securities (except pursuant to an effective registration statement), to give written notice to the Company of such holder's intention to effect such transfer and agrees to comply in all other respects with the provisions of this Article IV. Each such notice shall describe the manner and circumstances of the proposed Transfer and, unless waived by the Company, shall be accompanied by the written opinion, addressed to the Company, of counsel for the holder of such Restricted Securities (which counsel shall be reasonably satisfactory to the Company) stating that in the opinion of such counsel (which opinion shall be reasonably satisfactory to the Company) such proposed Transfer does not involve a transaction requiring registration or qualification of such Restricted Securities under the Securities Act or the securities laws of any state of the United States. Subject to complying with the other applicable provisions hereof, such holder of Restricted Securities shall be entitled to consummate such Transfer in accordance with the terms of the notice delivered by it to the Company if the Company does not object (on the basis that such transfer violates the provisions of this Article IV or applicable law) to such transfer within five days after the delivery of such notice. Each certificate or other instrument evidencing the Securities issued upon the transfer of any
Restricted Securities (and each certificate or other instrument evidencing any untransferred balance of such securities) shall bear the legend set forth in Section 4.2 unless (i) in such opinion of such counsel registration of the future transaction is not required by the applicable provisions of the Securities Act or the securities laws of any state of the United States, or (ii) the Company shall have waived the requirement of such legend.

4.5 Removal of Legends, Etc.

Notwithstanding the foregoing provisions of this Article IV, the restrictions imposed by Sections 4.1, 4.2 and 4.3 upon the transferability of any Restricted Securities shall cease and terminate when (i) such Restricted Securities are sold or otherwise disposed of in accordance with the intended method of disposition by the seller or sellers thereof set forth in a registration statement or are sold or otherwise disposed of in a transaction contemplated by Section 4.3 which does not require that the Securities transferred bear the legend set forth in Section 4.2, or (ii) the holder of such Restricted Securities has met the requirement of transfer of such Restricted Securities pursuant to subparagraph (k) of Rule 144. Whenever the restrictions imposed by Sections 4.1, 4.2 and 4.3 shall terminate, as herein provided, the holder of any Restricted Securities shall be entitled to receive from the Company, without expense, a new certificate not bearing the restrictive legend set forth in Section 4.2 and not containing any other reference to the restrictions imposed by Sections 4.1, 4.2 and 4.3.

ARTICLE V

Amendment and Waiver

5.1 Amendment.

Without limiting any other provision of this Agreement, the Charter, the By-laws or Applicable Law that requires a separate or greater vote by those Persons entitled to vote on any matter governed by such provision, any term or provision of this Agreement, the Charter and the By-laws may be amended, modified or waived only with the prior written consent of (a) the Company and (b) a majority of the Shareholders; provided, however, that:

(i) any such amendment, modification, or waiver that would adversely affect the rights hereunder of the Stockholders, collectively as a class, in their capacities as Stockholders hereunder, without similarly adversely affecting the rights hereunder of all Stockholders, in their capacities as Stockholders hereunder, shall not be effective as to the Stockholders, collectively as a class, without the prior written consent of the Stockholders (in which case such amendment, modification, or waiver as so approved shall be binding on all Stockholders);

(ii) any such amendment, modification, or waiver that would adversely affect the rights hereunder of any single Stockholder, in his, her or its capacity as a Stockholder hereunder, without similarly adversely affecting the rights
Appendix J: Stockholders Agreement

5.2 Waiver.

No course of dealing between the Company and the Stockholders (or any of them) or any delay in exercising any rights hereunder will operate as a waiver of any rights of any party to this Agreement. The failure of any party to enforce any of the provisions of this Agreement will in no way be construed as a waiver of such provisions and will not affect the right of such party thereafter to enforce each and every provision of this Agreement in accordance with its terms.

ARTICLE VI
Duration; Termination

The provisions of this Agreement, except as otherwise expressly provided herein, shall terminate upon the first to occur of (A) the dissolution, liquidation or winding-up of the Company, (B) the written approval of such termination by (i) the Company, and (ii) an majority of the Stockholders, and/or (C) the completion of an initial public offering of the Company, or (D) ten years from the date hereof. Anything contained herein to the contrary notwithstanding, (A) as to any particular Stockholder, this Agreement shall no longer be binding on or of further force or effect as to such Stockholder, except as otherwise expressly provided herein, as of the date such Stockholder has Transferred all of such Stockholder's interest in the Company's Securities and the Transferees of such Securities have, if required by Section 2.1 hereof, executed Joinder Agreements, and (B) if the Company completes an initial public offering prior to the fifth anniversary of the date hereof, all of the provisions of this Agreement shall continue in effect (including without limitation the restrictions set forth in Articles II and III hereof) with respect to any and all Shares owned by the Stockholders except to the extent that any of such Shares would otherwise be salable at the Market Price thereof under the Purchase Price Formula, in which case such restrictions shall lapse only upon (x) the sale of such Shares in the initial public offering of the Company or thereafter pursuant to an exemption from registration such as Rule 144 as permitted herein, or (y) upon the passage of time as provided under the Purchase Price Formula and then only as to that portion of the Shares that would otherwise be subject to purchase at the Market Price under the Purchase Price Formula.
ARTICLE VII

Miscellaneous

7.1 Severability.

It is the desire and intent of the parties hereto that the provisions of this Agreement be enforced to the fullest extent permissible under the laws and public policies applied in each jurisdiction in which enforcement is sought. Accordingly, if any particular provision of this Agreement shall be adjudicated by a court of competent jurisdiction to be invalid, prohibited or unenforceable for any reason, such provision, as to such jurisdiction, shall be ineffective, without invalidating the remaining provisions of this Agreement or affecting the validity or enforceability of this Agreement or affecting the validity or enforceability of such provision in any other jurisdiction. Notwithstanding the foregoing, if such provision could be more narrowly drawn so as not to be invalid, prohibited or unenforceable in such jurisdiction, it shall, as to such jurisdiction, be so narrowly drawn, without invalidating the remaining provisions of this Agreement or affecting the validity or enforceability of such provision in any other jurisdiction.

7.2 Entire Agreement.

This Agreement and the other agreements referred to herein and to be executed and delivered in connection herewith embody the entire agreement and understanding among the parties hereto with respect to the subject matter hereof and thereof and supercede and preempt any and all prior and contemporaneous understandings, agreements, arrangements or representations by or among the parties, written or oral, which may relate to the subject matter hereof or thereof in any way. Other than this Agreement and the other agreements referred to herein and to be executed and delivered in connection herewith, there are no other agreements continuing in effect relating to the subject matter hereof.

7.3 Successors and Assigns.

Except as otherwise provided herein, this Agreement will bind and inure to the benefit of and be enforceable by the Company and its successors and assigns and the Stockholders and any subsequent holders of Shares and the respective successors and assigns of each of them, so long as they hold Shares. None of the provisions hereof shall be construed or deemed to create, any right to employment in favor of any Person by the Company or any of its Subsidiaries. This Agreement is not intended to create any third party beneficiaries.

7.4 Counterparts.

This Agreement may be executed in any number of counterparts, and each such counterpart hereof shall be deemed to be an original instrument, but all such counterparts together shall constitute but one agreement.

(a) Each Stockholder shall have all rights and remedies reserved for such Stockholder pursuant to this Agreement and all rights and remedies which such holder has been granted at any time under any other agree-
ment or contract and all of the rights which such holder has under any law or equity. Any Person having any rights under any provision of this Agreement will be entitled to enforce such rights specifically, to recover damages by reason of any breach of any provision of this Agreement and to exercise all other rights granted by law or equity.

(b) The parties hereto agree that if any parties seek to resolve any dispute arising under this Agreement pursuant to a legal proceeding, the prevailing parties to such proceeding shall be entitled to receive reasonable fees and expenses (including reasonable attorney's fees and expenses) incurred in connection with such proceedings.

(c) It is acknowledged that it will be impossible to measure in money the damages that would be suffered by any party hereto if any Person also a party hereto fails to comply with any of the obligations imposed on it in this Agreement or in the Charter or By-laws and that in the event of any such failure, the aggrieved party will be irreparably damaged and will not have an adequate remedy at law. Any such aggrieved party shall, therefore, be entitled to injunctive relief, including specific performance, to enforce such obligations, and if any action should be brought in equity to enforce any of the provision of this Agreement, none of the parties hereto shall raise the defense that there is an adequate remedy at law.

7.5 Notices.

All notices or other communications which are required or otherwise delivered hereunder shall be deemed to be sufficient and duly given if contained in a written instrument (a) personally delivered or sent by facsimile transmission, receipt confirmed, (b) sent by nationally-recognized overnight courier guaranteeing next Business Day delivery, or (c) sent by first class registered or certified mail, postage prepaid, return receipt requested, addressed as follows:

If to the Company, to:

Company

__________________________

__________________________

__________________________

with copies to:

Berliner Zisser Walter & Gallegos, P.C.
1700 Lincoln Street, Suite 4700
Denver, Colorado 80203-4547
Facsimile: (303) 830-1705
Attn: Robert W. Walter, Esq.
or to such other address as the party to whom notice is to be given may have furnished to each other party in writing in accordance herewith. Any such notice or communication shall be deemed to have been received (i) when delivered, if personally delivered or sent by receipt confirmed facsimile transmission, (ii) on the first Business Day after dispatch, if sent by nationally-recognized overnight courier guaranteeing next Business Day delivery, and (iii) on the eighth Business Day following the date on which the piece of mail containing such communication is posted, if sent by mail.

7.6 Governing Law; Consent to Jurisdiction.

All questions concerning the construction, interpretation and validity of this Agreement shall be governed by and construed and enforced in accordance with the domestic laws of the State of Delaware, United States, without giving effect to any choice or conflict of law provision or rule (whether in the State of Delaware or any other jurisdiction) that would cause the application of the laws of any jurisdiction other than the State of Delaware. In furtherance of the foregoing, the internal law of the State of Delaware will control the interpretation and construction of this Agreement, even if under such jurisdiction’s choice of law or conflict of law analysis, the substantive law of some other jurisdiction would ordinarily apply.

7.7 Conflicting Agreements.

No Stockholder shall enter into any stockholder agreements or arrangements of any kind with any Person with respect to any Securities on terms inconsistent with the provisions of this Agreement (whether or not such agreements or arrangements are with other Stockholders or with Persons that are not parties to
this Agreement), including agreements or arrangements with respect to the Holdings or disposition of Securities of the Company in a manner which is inconsistent with this Agreement.

7.8 **Mutual Waiver of Jury Trial.**

DISPUTES ARISING IN CONNECTION WITH COMPLEX FINANCIAL TRANSACTIONS ARE MOST QUICKLY AND ECONOMICALLY RESOLVED BY AN EXPERIENCED AND EXPERT PERSON AND THE PARTIES WISH APPLICABLE LAWS TO APPLY (RATHER THAN ARBITRATION RULES), THE PARTIES DESIRE THAT THEIR DISPUTES BE RESOLVED BY A JUDGE APPLYING APPLICABLE LAWS. THEREFORE, TO ACHIEVE THE BEST COMBINATION OF THE BENEFITS OF THE JUDICIAL SYSTEM AND OF ARBITRATION, THE PARTIES HERETO WAIVE ALL RIGHT TO TRIAL BY JURY IN ANY ACTION, SUIT OR PROCEEDING BROUGHT TO ENFORCE OR DEFEND ANY RIGHTS OR REMEDIES UNDER THIS AGREEMENT OR ANY DOCUMENTS RELATED HERETO.

7.9 **Counterparts; Validity.**

This Agreement may be executed in counterparts and telecopied signatures are effective. The failure of any Stockholder to execute this Agreement does not make it invalid as against any other Stockholder.

7.10 **Consent of Spouses.**

If requested by the Company, each Stockholder who is an individual shall cause his or her spouse, as applicable to execute and deliver a separate consent and agreement in a form reasonably acceptable to the Company (a “Spousal Consent”). The signature of a spouse on a Spousal Consent shall not be construed as making such spouse a stockholder of the Company or a party to this Agreement, except as may otherwise be set forth in such consent. Each Stockholder who is an individual will certify his or her marital status to the Company at the Company’s request. The Company will request Spousal Consents as contemplated by this Section 7.10 whenever such action may be advantageous in enforcing (or assuring the enforceability of in the future) the terms of this Agreement.

7.11 **Rules of Construction.**

The use in this Agreement of the term “including” means “including, without limitation.” The words “herein,” “hereof,” “hereunder” and other words of similar import refer to this Agreement as a whole, including the schedules and exhibits, as the same may from time to time be amended, modified, supplemented or restated, and not to any particular section, subsection, paragraph, subparagraph or clause contained in this Agreement. All references to sections, schedules and exhibits mean the sections of this Agreement and the schedules and exhibits attached to this Agreement, except where otherwise stated. The title of and the section and paragraph headings in this Agreement are for convenience of reference only and shall not govern or affect the interpretation of any
of the terms or provisions of this Agreement. The use herein of the masculine, feminine or neuter forms shall also denote the other forms, as in each case the context may require. Where specific language is used to clarify by example a general statement in any context contained herein, such specific language shall not be deemed to modify, limit or restrict in any manner the construction of the general statement to which it relates. The language used in this Agreement has been chosen by the parties to express their mutual intent, and no rule of construction shall be applied against any party.

IN WITNESS WHEREOF, the undersigned have duly executed this Stockholders Agreement as of the date first written above.

Company

By:

Stockholder 1

Stockholder 2

Stockholder 3
APPENDIX K

REGISTRATION RIGHTS AGREEMENT*

THIS REGISTRATION RIGHTS AGREEMENT (this "Agreement") is dated effective as of __________, 2002 (the "Effective Date") by and among (i) the purchasers of certain preferred stock listed on the signature pages hereto and each other Person (defined below) who becomes a party to this Agreement simultaneously with becoming a party pursuant to and in accordance with the terms and conditions set forth in that certain Purchase Agreement (defined below) on, or before, July 31, 2003 (each a "Holder" and, collectively the "Holders"), and (ii) Company (the "Company").

RECITALS

The Holders are parties to a Securities Purchase Agreement dated for reference purposes as of even date herewith by and between the Company and the Holders (the "Purchase Agreement") pursuant to which the Company is obligated to enter into this Agreement. All capitalized terms not defined herein shall have the meaning established in the Purchase Agreement.

AGREEMENT

NOW, THEREFORE, in consideration of the mutual agreements, covenants, representations and warranties contained in this Agreement, the parties hereto hereby agree as follows:

1. Definitions.

1.1 "Commission" means the Securities and Exchange Commission or any other Federal agency at the time administering the Securities Act.

* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
1.2 "Common Stock" means any common stock issued or issuable upon conversion of the Series A Convertible Preferred Stock.

1.3 "Exchange Act" means the Securities Exchange Act of 1934, as amended, or any similar Federal statute and the rules and regulations of the Commission thereunder all as the same shall be in effect at the time.

1.4 "Person" means any individual, corporation, trust, partnership, association, or other entity.

1.5 "Registrable Shares" means the Common Stock.

1.6 "Registration Statement" means the registration statements filed with the Commission as contemplated by Section 2, including (in each case) any prospectus, amendments and supplements to such Registration statement or Prospectus, including pre- and post-effective amendments, all exhibits thereto, and all material incorporated by reference in such registration statement or statements.

1.7 "Securities Act" means the Securities Act of 1933, as amended, or any similar Federal statute and the rules and regulations of the Commission thereunder, all as the same shall be in effect at the time.

1.8 "Untrue Statement" shall include any untrue statement or alleged untrue statement in the Registration Statement, or any omission or alleged omission to state in the Registration Statement a material fact required to be stated therein or necessary to make the statements therein, in light of the circumstances under which they were made, not misleading.

2. Registration Procedures and Expenses. The duties and obligations of the Company outlined in this Section 2 shall come into effect only upon the Company closing an initial public offering of its securities and becoming a publicly traded company (the "IPO Closing"). Upon the IPO Closing, the Company is obligated to do the following:

(a) Demand Rights.

   (i) Upon receipt of a request by holders of a least 20 percent of the Common Stock, no earlier than six months after the IPO Closing of the Company and no later than five years after the IPO Closing, that the Company file a registration statement covering a number of Common Stock shares with expected gross proceeds of $15 million or greater;

   (ii) within 60 days following receipt of the request, prepare and file with the Commission a Registration Statement on Form S-1 or Form SB-2 in order to register with the Commission under the Securities Act a sale by the Holders in accordance with the method or methods of distribution thereof as reasonably specified by the Holders on a delayed or continuous basis pursuant to Rule 415 under the Securities Act all of the Registrable Shares (notwithstanding anything to the contrary expressed or implied herein, if a registration statement on Form S-3, or any substitute form, becomes available for registration of the Registrable Shares, the Company may instead prepare and file with the
Commission a registration statement on Form S-3 at any time in order to register the Registrable Shares under the Securities Act and such registration statement will be a "Registration Statement" for the purposes of this Agreement); and

(iii) except that the Company is not obligated to effect more than two registrations under this section, unless the registrations are made on Form S-3 in which case the provisions of Section 2(b) shall apply:

(b) within 60 days of receipt of a request by holders of Common Stock, file up to three Registration Statements on Form S-3 provided the anticipated aggregate offering price in each registration on Form S-3 will exceed $1,000,000 and subject to certain delay and holdback provisions;

(c) effect registration of Common Stock upon exercise of "piggy-back" registration rights by holders of the Common Stock;

(d) use its best efforts, subject to receipt of necessary information from the Holders, to cause such Registration Statement to become effective no later than 120 days following receipt of the request;

(e) promptly notify each Holder, at any time when a prospectus relating to such Registration Statement is required to be delivered under the Securities Act, of the happening of any event as a result of which the prospectus included in or relating to such Registration Statement contains an Untrue Statement;

(f) promptly prepare and file with the Commission, and deliver to each Holder, such amendments and supplements to such Registration Statement and the prospectus used in connection therewith as may be necessary to keep such Registration Statement effective and to comply with the provisions of the Securities Act with respect to the sale or other disposition of all Registrable Shares until termination of such obligation as provided in Section 2.5 below;

(g) furnish to each Purchaser such number of copies of prospectuses, including preliminary prospectuses, in conformity with the requirements of the Securities Act, in order to facilitate the public sale or other disposition of all or any of the Registrable Shares by the Holders;

(h) file such documents as may be required of the Company for normal securities law clearance for the resale of the Registrable Shares in any state reasonably requested by the Holders; provided, however, that the Company shall not be required in connection with Paragraph (f) to (i) qualify as a foreign corporation to do business under the laws of any jurisdiction in which it shall not then be qualified or execute a general consent to service of process in any jurisdiction, or (ii) undertake any filing obligations in those states where the Company does not meet such filing requirements;

(i) use its best efforts to cause all Registrable Shares to be listed on each securities exchange, quotation system or over-the-counter market on which equity securities by the Company are then listed or traded;
(j) bear all expenses in connection with this Agreement, including, without limitation, all registration and filing fees (including all expenses incident to filing with the NASD), printing expenses, fees and disbursements of counsel for Company, expenses of any special audits incident to or required by any such Registration and expenses of complying with the securities or blue sky laws of any jurisdiction, other than (i) fees and expenses, if any, of counsel or other advisors to the Holders, and (ii) brokers commissions, discounts or fees and transfer taxes; and

(k) take all reasonable actions required to prevent the entry of any stop order issued or threatened by the Commission or any state regulatory authority with respect to any Registration Statement covering Registrable Shares, and take all reasonable actions to remove it if entered.

2.1 Indemnification.

(a) The Company agrees to indemnify and hold harmless each Holder, such Holder's directors, officers, partners, agents, each underwriter of Registered Shares, and each Person who controls any of the foregoing (within the meaning of Section 15 of the Securities Act) (each an "Indemnified Party") from and against any losses, claims, damages or liabilities to which such Indemnified Party may become subject (under the Securities Act or otherwise) insofar as such losses, claims, damages or liabilities (or actions or proceedings in respect thereof) arise out of, or are based upon, any Untrue Statement in the Registration Statement, or arise out of any failure by the Company to fulfill any undertaking included in the Registration Statement or arise under the Securities Act or any other statute or at common law and the Company will reimburse such Indemnified Party for any reasonable legal or other expenses reasonably incurred in investigating, defending or preparing to defend any such action, proceeding or claim; provided, however, that the Company shall not be liable in any such case to the extent that such loss, claim, damage or liability arises out or, or is based upon, an Untrue Statement made in such Registration Statement in reliance upon and in conformity with written information furnished to the Company by or on behalf of such Indemnified Party specifically for use in preparation of the Registration Statement or the failure of such Holder to comply with the covenants and agreements contained in Section 2.3 hereof respecting the sale of the Registrable Shares or any Untrue Statement in any prospectus that is corrected in any subsequent prospectus that was delivered to the Holder prior to the pertinent sale or sales by the Holder.

(b) Each Holder, severally and jointly, agrees to indemnify and hold harmless the Company (and each Person, if any, who controls the Company within the meaning of Section 15 of the Securities Act, each officer of the Company who signs the Registration Statement and each director of the Company) from and against any losses, claims, damages or liabilities to which the Company (or any such officer, directors or controlling person) may become subject (under the Securities Act or otherwise), insofar as such losses, claims, damages or liabilities (or actions or proceedings in respect thereof) arise out or, or are based upon, any failure to comply with the covenants and agreements contained in Section 2.3
hereof respecting sale of the Registrable Shares, or any Untrue Statement contained in the Registration Statement and such Holder will reimburse the Company (or such officer, director or controlling person), as the case may be, for any legal or other expense reasonably incurred in investigating, defending or preparing to defend any such action, proceeding or claim; provided that in no event shall any indemnity by a Holder under this Section 2.2 exceed the net proceeds received by such Holder from the sale of the Registrable Shares covered by such Registration Statement.

(c) Promptly after receipt by any indemnified person of a notice of a claim or the beginning of any action in respect of which indemnity is to be sought against an indemnifying person pursuant to this Section 2.1, such indemnified person shall notify the indemnifying person in writing of such claim or of the commencement of such action, and, subject to the provisions hereinafter stated, in case any such action shall be brought against an indemnified person and such indemnifying person shall have been notified thereof, such indemnifying person shall be entitled to participate therein, and, to the extent it shall wish, to assume the defense thereof, with counsel reasonably satisfactory to such indemnified person. After notice from the indemnifying person to such indemnified person of its election to assume the defense thereof, such indemnifying person shall not be liable to such indemnified person for any legal expenses subsequently incurred by such indemnified person in connection with the defense thereof; provided, however, that if there exists or shall exist a conflict of interest that would make it inappropriate, in the opinion of counsel to the indemnified person, for the same counsel to represent both the indemnified person and such indemnifying person or any affiliate or associate thereof, the indemnified person shall be entitled to retain its own counsel at the expense of such indemnifying person; provided, however, that no indemnifying person shall be responsible for the fees and expenses of more than one separate counsel for all indemnified parties. No indemnifying party in the defense of any such claim or litigation shall, except with the consent of each indemnified party, consent to entry of any judgment or enter into any settlement that does not include as an unconditional term thereof the giving by the claimant or plaintiff to such indemnified party of a release from all liability in respect of such claim or litigation without the prior written consent of the indemnifying party.

(d) If the indemnification provided for in this Section 2.1 is held by a court of competent jurisdiction to be unavailable to an indemnified party with respect to any loss, liability, claim, damage or expense referred to therein, then the indemnifying party, in lieu of indemnifying such indemnified party hereunder, shall contribute to the amount paid or payable by such indemnified party as a result of such loss, liability, claim, damage or expense in such proportion as is appropriate to reflect the relative fault of the indemnifying party on the one hand and of the indemnified party on the other in connection with the statements or omission that resulted in such loss, liability, claim, damage or expense as well as any other relevant equitable considerations. The relative fault of the indemnifying party and of the indemnified party shall be determined by reference
to, among other things, whether the Untrue Statement or alleged Untrue Statement of material fact or the omission to state a material fact relates to information supplied by the indemnifying party or by the indemnified party and the parties' relative intent, knowledge, access to information, and opportunity to correct or prevent such statement or omission. No Person guilty of fraudulent misrepresentation (within the meaning of Section 11(f) of the Securities Act) shall be entitled to contribution from any Person who was not guilty of such fraudulent misrepresentation. Notwithstanding anything to the contrary contained herein, any contribution by a Holder hereunder shall not exceed the net proceeds received by such Holder from the sale of the Registrable Shares covered by the Registration Statement.

2.2 Penalty Payment.

(a) In the event that the Registration Statement required to be filed pursuant to Section 2 relating to Registrable Shares shall not be declared effective by the Commission within one hundred twenty (120) days from receipt of a request by a Holder to register the shares (the "Final Registration Date"), the Company shall pay each Holder, in cash, one percent (1%) of such Holder's Purchase Price (prorated for partial periods) with such payment made pursuant to this Section 2.2 (referred to as a "Penalty Payment"), within ten (10) days of the end of each thirty (30) day period following the Final Registration Date, for each such thirty (30) day period, until the earlier to occur of (i) the effectiveness of the Registration Statement covering the Registrable Shares, or (ii) until each such Holder is permitted to publicly sell all of the shares of Common Stock owned by such Holder during any 3 month period pursuant to Rule 144. For example, if the Registration Statement becomes effective on the 135th day following the receipt of a request by a Holder to register the shares, the Penalty Payment shall equal 1½% of such Holder's Purchase Price.

(b) The remedies provided for in this Section 2.2 shall be in addition to any other remedies available to the Holders under this Agreement, at law or in equity.

2.3 Transfer of Shares After Registration; Notice. The Holder hereby covenants with the Company not to make any sale of the Registrable Shares after registration without effectively causing the prospectus delivery requirement under the Securities Act to be satisfied. The Holder acknowledges that there may be times when the Company must suspend the use of the prospectus forming a part of the Registration Statement until such time as an amendment to the Registration Statement has been filed by the Company and declared effective by the Commission, or until such time as the Company has filed an appropriate report with the Commission pursuant to the Exchange Act. The Holder hereby covenants that it will not sell any Registrable Shares pursuant to said prospectus during the period commencing at the time at which the Company gives the Holder notice of the suspension of the use of said prospectus and ending at the time the Company gives the Holder notice that the Holder may thereafter effect sales pursuant to said prospectus; provided, however, that no such postponement shall be permitted for more than 90 days during any 12 month period. The foregoing pro-
visions of this Section 2.3 shall in no manner diminish or otherwise impair the Company’s obligations under Section 2.

2.4 Reporting Requirements.

(a) At such time as the Company shall have had its IPO Closing, the Company agrees to use its best efforts to:

(i) make and keep public information available, as those terms are understood and defined in Rule 144 under the Securities Act;

(ii) file with the Commission in a timely manner all reports and other documents required of the Company under the Securities Act and the Exchange Act; and

(iii) so long as any of the Holders own Registrable Shares, to furnish to the Holders forthwith upon request (1) a written statement by the Company as to whether it complies with the reporting requirements of said Rule 144, the Securities Act and the Exchange Act, or whether it qualified as a registrant whose securities may be resold pursuant to Commission Form S-3, (2) a copy of the most recent annual or quarterly report of the Company and such other reports and documents so filed by the Company, and (3) such other information as may be reasonably requested in availing the Holders of any rule or regulation of the Commission that would permit the selling of the Registrable Shares without registration.

2.5 Termination of Obligations. The obligations of the Company pursuant to Sections 2 through 2.4 hereof shall cease and terminate upon the earlier to occur of (i) such time as all of the Registrable Shares have been resold, or (ii) such time as all of the Registrable Shares may be sold during any 3 month period pursuant to Rule 144, including Rule 144(k), or (iii) upon the second anniversary date of the date of effectiveness of the Registration Statement.

2.6 Transferability of Registration Rights. The Registration rights set forth in this Section 2 are transferable provided the Company is given notice by the transferor and the transferee agrees to be bound by the Purchase Agreement and any ancillary documents. The Registration Rights shall not be transferred to a competitor and shall not violate the Securities Act.

3. Miscellaneous.

(a) Consent to Amendments. Except as otherwise expressly provided herein, the provisions of this Agreement may be amended and/or the provisions hereof waived, only with the written consent of the Company and of Holders holding fifty percent (50%) or more of the Registrable Shares at the time held by all Holders. Notwithstanding the foregoing, no amendment or waiver may affect any Holder in any manner differently from any other Holder without the written consent of such first mentioned Holder. No course of dealing between the Company and any Holder or any delay in exercising any rights hereunder or under the Company’s Certificate of Incorporation will operate as a waiver of any rights of any such Holder.
(b) **Successors and Assigns.** All covenants and agreements contained in this Agreement by or on behalf of any of the parties hereto shall bind and inure to the benefit of the respective successors and assigns of the parties hereto whether so expressed or not.

(c) **Severability.** Each provision of this Agreement shall be interpreted in such manner as to be effective and valid under applicable law, but if any provision of this Agreement is held to be prohibited by or invalid under applicable law, such provision shall be ineffective only to the extent of such prohibition or invalidity, without invalidating the remainder of this Agreement.

(d) **Counterparts.** This Agreement may be executed in two or more counterparts, any one of which need not contain the signatures of more than one party, but all such counterparts when taken together shall constitute one and the same Agreement.

(e) **Descriptive Headings.** The descriptive headings of this Agreement are inserted for convenience only and do not constitute a part of this Agreement.

(f) **Notices.** All notices, demands, consents or other communications required or permitted hereunder shall be in writing and shall be deemed to have been given (i) when personally delivered, (ii) three (3) business days following mailing thereof, if sent by first class certified mail, return receipt requested, or (iii) the next business day following transmission or mailing, if sent by facsimile (receipt confirmed and followed up by one of the other delivery methods discussed herein as well), Express Mail, Federal Express or similar service, addressed as follows:

If to any Holder: To the applicable addresses set forth in the Purchase Agreement

If to the Company: Company

____________________________________

_____________________________

Attn: _________________

Fax No.: ______________

With a copy to: Berliner Zisser Walter & Gallegos, P.C.
1700 Lincoln Street, Suite 4700
Denver, Colorado 80203-4547
Attn: Robert W. Walter, Esq.
Fax No.: (303) 830-1705

Any party may change its address for purposes hereof by notice given in accordance with this Section 3(f) to each of the other parties hereto.
(g) **Governing Law.** The validity, meaning and effect of this Agreement, and all amendments and supplements hereto and all waivers and consents hereunder, shall be determined in accordance with the laws of Delaware, applicable to the contracts made and to be performed entirely within the State of Delaware. Each of the parties hereby submits to personal jurisdiction in the County of ________, State of Delaware solely for purposes of this Agreement and waives any objection as to venue in the County of ________, State of Delaware.

(h) **Litigation Costs.** Subject to Section 2.1, if any legal action or any arbitration or other proceeding is brought for the enforcement of this Agreement, or because of a dispute, breach, default, or misrepresentation in connection with any of the provisions of this Agreement, the successful or prevailing party or parties shall be entitled to recover reasonable attorneys' fees and other costs incurred in that action or proceeding, in addition to any other relief to which it or they may be entitled, if and only to the extent that the applicable arbitrator or court shall so direct and such direction is final and not subject to appeal or review.

(i) **Specific Performance.** Each party’s obligation under this Agreement is unique. If any party should default in its obligations under this Agreement, the parties each acknowledge that it would be extremely impracticable to measure the resulting damages; accordingly, each non-defaulting party, in addition to any other available rights or remedies, may sue in equity for specific performance, and the parties each expressly waive the defense that a remedy in damages will be adequate.

(j) **Integration.** This instrument constitutes the entire agreement of the parties hereto respecting the registration of the Registrable Shares by the Holders and correctly sets forth the rights, duties and obligations of each party hereto to the others in relation thereto as of its date. Any prior agreements, promises, negotiations or representations concerning its subject matter which are not expressly set forth in this Agreement are merged into this Agreement.

(k) **No Inconsistent Agreements: Agreement to Amend.** The Company will not hereafter enter into any agreement with respect to its securities that is inconsistent with or violates the rights granted to the holders of Registrable Shares in this Agreement. Notwithstanding the foregoing, in the event that the Company enters into an agreement under which it issues Series A Convertible Preferred Stock (the “Preferred Stock”) for a purchase price of a minimum of $8 million, to the extent (if at all) the registration rights extended to the purchasers of the Preferred Stock are inconsistent with the terms of this Agreement, the Company and the Holders agree to execute any and all further instruments or documents, specifically including, but not limited to, executing an amendment to this Agreement, which shall conform the terms hereof to the terms of any registration rights granted to the purchasers of the Preferred Stock. This covenant and agreement shall survive the execution and delivery hereof.
IN WITNESS WHEREOF, the parties hereto have executed this Agreement as of the date first above written.

THE COMPANY:

COMPANY

By: ___________________________ Date: __________________

OTHER PARTIES:

By: ___________________________ Date: __________________
By: ___________________________ Date: __________________
By: ___________________________ Date: __________________
By: ___________________________ Date: __________________
APPENDIX L

SUBORDINATED LOAN AGREEMENT*

This SUBORDINATED LOAN AGREEMENT, dated as of September ____, 2002, is between __________, a _______ corporation (the "Borrower") and _________ ("Lender") (all other capitalized terms used herein are defined in Section 1.1 below).

RECITALS:

A. Borrower desires to borrow up to a maximum of $25,000,000 in principal from Lender for the purpose of funding additional working capital requirements; and

B. Lender has agreed to make the Loan upon the terms and subject to the conditions set forth herein.

NOW, THEREFORE, it is agreed as follows:

ARTICLE I

DEFINITIONS AND DETERMINATIONS

1.1 Definitions. As used in this Loan Agreement, unless otherwise expressly indicated herein, the following terms shall have the following meanings (such meanings to be applicable equally to both the singular and plural forms of the terms defined):

BORROWER: has the meaning assigned to that term in the Preamble to this Loan Agreement;

Accountants: Arthur Andersen, L.L.P. or any other independent certified public accounting firm selected by Borrower and reasonably satisfactory to Lender;

* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
Accounting Changes: has the meaning set forth in Section 1.3 of this Loan Agreement;

Acquisition: the purchase of in excess of 50% of the capital stock of any Person by any other Person, whether by transfer of outstanding shares or through a new issuance, or through a tender or exchange offer, merger or other business combination, and the sale or disposition of assets (including by way of merger) constituting in excess of 25% of the Consolidated Assets of such Person as of the date of such sale or disposition;

ADA: the Americans with Disabilities Act of 1990, as amended, any successor statute thereto, and the rules and regulations issued thereunder, as in effect from time to time;

Advance: a disbursement of the proceeds of the Loan;

Affiliate: with respect to Borrower (or any other specified Person), any other Person directly or indirectly controlling, controlled by or under direct or indirect common control with Borrower (or such specified Person) and shall include (a) any officer or director or of Borrower (or such specified Person), (b) any Person of which Borrower (or such specified Person) or any Affiliate (as defined in clause (a) above) of Borrower (or such specified Person) shall, directly or indirectly, beneficially own either (i) at least 10% of the outstanding equity securities having the general power to vote, or (ii) at least 10% of the interests, or (c) any Person directly or indirectly controlling Borrower (or such specified Person) through a management agreement, voting Agreement or other contract;

Agent: Lender in its capacity as agent for the Lenders hereunder, as well as its successors and assigns in such capacity pursuant to Section 10 of this Loan Agreement;

Assignee: has the meaning set forth in Section 9.12.1 of this Loan Agreement;

Assignment and Acceptance: has the meaning set forth in Section 9.12.1 of this Loan Agreement;

Bank: ____________, a national banking association;

Bank Loan Agreement: the loan agreement dated as of __________ by and between ________ and Bank, as the same may be amended, restated, supplemented or otherwise modified from time to time;

Bank Loan Documents: has the meaning given to the term in the Bank Loan Agreement;

Bankruptcy Code: the United States Bankruptcy Code and any successor statute thereto, and the rules and regulations issued thereunder, as in effect from time to time;

Benchmark: has the meaning set forth in Section 5.10 of this Loan Agreement;

Borrower: __________;
Borrower's Business: ____________________________;

Borrower's Obligations: any and all Indebtedness due or to become due, now existing or hereafter arising, under this Loan Agreement and the Note from Borrower to Lender;

Business Day: any day other than a Saturday, Sunday or other day on which banks in New York, New York are required to close;

Business Insurance: such property, casualty, business interruption and other insurance, other than Key Man Life Insurance, as is required pursuant to the terms of the Senior Indebtedness Due Bank;

Capital Stock: collectively, all of the issued and outstanding capital stock, warrants, options and other equity interests of the Obligors;

Capitalized Lease: any lease of Property, the obligations for the rental of which are required to be classified and accounted for as a capital lease on the balance sheet in accordance with GAAP;

Capitalized Lease Obligations: the amount of the liability reflecting the aggregate discounted amount of future payments under all Capital Leases calculated in accordance with GAAP, including Statement Nos. 13 and 98 of the Financial Accounting Standards Board;

Change in Control: means the occurrence of (i) the acquisition (whether publicly or otherwise) of Common Stock of Borrower, or beneficial ownership thereof, by any Person, acting alone or as part of a "group" (as such term is used in Section 13(d)(3) of the Securities Exchange Act of 1934) exceeding 33.3% of the outstanding Common Stock, with a stated intention to acquire or affect control of Borrower or influence the management, Board of Directors or policies of Borrower, (ii) the sale on or before the fourth anniversary of this Loan Agreement by the Management Team of in excess of 25% of the number of shares of Common Stock collectively owned by such persons at the date of this Loan Agreement, or (iii) the sale, on or before repayment in full of the Borrower's Obligations to Lender, by the Management Team of in excess of 45% of the number of shares of Common Stock collectively owned by such persons at the date of this Loan Agreement;

Chief Financial Officer: the chief financial officer of Borrower, who is a duly elected officer of Borrower;

Closing and Closing Date: mean the date on which the Advance is made pursuant to Section 2.1 of this Loan Agreement, or September ____, 2002;

Code: the Internal Revenue Code of 1986, as amended, and any successor statute thereto, and the rules and regulations issued thereunder, as in effect from time to time;

Common Stock: the class of voting shares of common stock of Borrower which shares at the date hereof are publicly traded on The Nasdaq National Market*;
Commitment: with respect to any Lender, such Lender's obligations to extend all or a portion of the Advance. The original Commitments are set forth in the Register and the subsequent Commitments will be recorded from time to time in the Register;

Company: has the meaning assigned to that term in the preamble to this Loan Agreement;

Competitive Business: means any business that competes with the Borrower or any of the Obligors in the business of providing _______ services, including but not limited to, sale and exchange of ___________________________; the operation of ___________________________. In the event the Borrower acquires any other entity conducting business within the _______ services industry not otherwise specified above, any additional operations, products or services provided by such acquired entity shall thereafter be included within the definition of a Competitive Business; provided, however, that if any Assignee or Lender acquires or owns an interest in an entity which only becomes a Competitive Business as a result of an acquisition of an entity by Borrower after the date of this Loan Agreement, the Assignee or Lender shall not be required to dispose of such ownership interest unless such Competitive Business competes with the business of the Borrower or any of the Obligors as of the date hereof;

Confidential Information: all information or material disclosed or provided by the Borrower to Lender, either orally or in writing, or obtained by Lender from a third party or any other source, concerning any aspect of the business or affairs of the Borrower or its “affiliates” (as such term is defined in Rule 12b-2 under the Securities Exchange Act of 1934), including without limitation, any information or material pertaining to products, formulae, specifications, designs, processes, plans, policies, procedures, employees, work conditions, legal and regulatory affairs, assets, inventory, discoveries, trademarks, patents, manufacturing, packaging, distribution, sales, marketing, expenses, financial statements and data, customer and supplier lists, raw materials, costs of goods and relationships with third parties. Confidential Information also includes any notes, analyses, compilations, studies or other material or documents prepared by Lender which contain, reflect or are based, in whole or in part, on the Confidential Information. Notwithstanding the foregoing, Confidential Information shall not include information or material that (i) is publicly available or becomes publicly available through no action or fault of Lender, (ii) was already in Lender's possession or known to Lender prior to being disclosed or provided to Lender by or on behalf of the Borrower, provided, that, the source of such information or material was not bound by a contractual, legal or fiduciary obligation of confidentiality, known to Lender, to the Borrower or any other party with respect thereto, or (iii) was or is obtained by Lender from a third party, provided, that, such third party was not bound by a contractual, legal or fiduciary obligation of confidentiality to the Borrower or any other party with respect to such information or material that is known to Lender;

Consolidated and Consolidating: when used with reference to any term, mean that term as applied to the accounts of Borrower (or other such Person) and
all of its Subsidiaries (or other specified group of Persons), or such of its Subsidiaries as may be specified, consolidated (or combined) or consolidating (or combining), as the case may be, in accordance with GAAP and with appropriate deductions for minority interests in Subsidiaries;

**Consolidated Amortization Expense:** for any Person means, for any period, the consolidated amortization expense of such Person for such period (including amortization of any step-up in value of inventory or other assets as may be required by purchase accounting), determined on a consolidated basis for such Person and its Subsidiaries in conformity with GAAP;

**Consolidated Assets:** at any date, all amounts carried as assets on the balance sheet of Borrower and its Subsidiaries determined in accordance with GAAP on a Consolidated basis;

**Consolidated Capital Expenditures:** for any Person means, for any period, the aggregate expenditures during that period for any fixed assets or improvements, or for replacements; substitutions or additions thereto, which have a useful life of more than one year and which are or should be reflected on such Person's consolidated statement of cash flows as capital expenditures of such Person and its consolidated Subsidiaries, determined in conformity with GAAP, but excluding expenditures made in connection with the replacement, substitution or restoration of assets (i) to the extent financed from insurance proceeds paid on account of the loss of or damage to the assets being replaced or restored, (ii) with awards of compensation arising from the taking by eminent domain or condemnation of the assets being replaced, or (iii) with regard to equipment that is purchased simultaneously with the trade-in of existing equipment, fixed assets or improvements, to the extent of the credit granted by the seller of such equipment for the trade-in of such equipment, fixed assets or improvements; provided that Consolidated Capital Expenditures shall in any event include the purchase price paid in connection with the acquisition of any other Person (including through the purchase of all of the capital stock or other ownership interest of such Person or through merger or consolidation) to the extent allocable to property, plant and equipment;

**Consolidated Depreciation Expense:** for any Person means, for any period, the consolidated depreciation expense of such Person for such period, determined on a consolidated basis for such Person and its consolidated Subsidiaries in conformity with GAAP;

**Consolidated EBITDA:** for any Person means, without duplication, for any period, the sum of the amounts for such period of (i) Consolidated Net Income, (ii) Consolidated Tax Expense, (iii) Consolidated Interest Expense, (iv) Consolidated Depreciation Expense, and (v) Consolidated Amortization Expense; provided that the sums included in clauses (ii) through (v) shall be added back only to the extent deducted in calculating Consolidated Net Income;

**Consolidated EBITDAC:** for any Person means, for any period, Consolidated EBITDA minus Consolidated Capital Expenditures and actual Consolidated Tax Expense paid by such Person in the four most recent complete calendar quarters;
Consolidated Interest Expense: for any Person shall mean, for any period, total interest expense (including that attributable to Capital Leases in accordance with GAAP) of such Person and its Subsidiaries on a consolidated basis net of interest income with respect to all outstanding Indebtedness of such Person and its Subsidiaries, including, without limitation, all commissions, discounts and other fees and charges owed with respect to letters of credit and bankers' acceptance financing, but excluding, however, any amortization of deferred financing costs, all as determined on a consolidated basis for such Person and its consolidated Subsidiaries in accordance with GAAP;

Consolidated Net Income: for any Person means, for any period, the net income (or loss) of such Person and its Subsidiaries on a consolidated basis for such period taken as a single accounting period determined on a consolidated basis for such Person and its consolidated Subsidiaries in conformity with GAAP; provided, however, that there shall be excluded (i) the income (or loss) of any other Person (other than consolidated Subsidiaries of such Person) in which any third Person (other than such Person or any of its consolidated Subsidiaries) has a joint interest, except to the extent of the amount of dividends or other distributions actually received by such Person or any of its consolidated Subsidiaries from such other Person during such period, (ii) the income (or loss) of any other Person accrued prior to the date it becomes a consolidated Subsidiary of such Person or is merged into or consolidated with such Person or any of its consolidated Subsidiaries or such other Person's assets are acquired by such Person or any of its consolidated Subsidiaries, (iii) the income of any consolidated Subsidiary of such Person to the extent that the declaration or payment of dividends or similar distributions by that consolidated Subsidiary of that income is not at the time permitted by operation of the terms of its charter or any agreement (other than this Loan Agreement), instrument, judgment, decree, order, statute, rule or governmental regulation applicable to that consolidated Subsidiary, and (iv) Consolidated net gains and losses from asset sales with respect to such period;

Consolidated Tax Expense: for any Person means, for any period, the consolidated tax expense of such Person for such period, determined on a consolidated basis for such Person and its consolidated Subsidiaries in conformity with GAAP;

Cumulative Return: means the aggregate and cumulative rate of return to Lender on the amount of the Loan that shall include (i) interest actually received by Lender and paid at either the Interest Rate or the Default Rate, (ii) the PIK, (iii) the Facility Fee, and (iv) the aggregate value of the Warrant, determined as of the date of notice provided from Lender to Borrower pursuant to Section 2.5.2 of this Loan Agreement, which determination shall be made by multiplying (x) the number of Warrant Shares issuable to Lender on exercise of the Warrant, by (y) the amount by which the then-market price per share of Common Stock exceeds the exercise price of the Warrant. In calculating the Cumulative Return, the amounts of the foregoing subparagraphs (i) through (iv) shall be added together with the Principal Balance of the Loan to be repaid by Borrower, and the sum total of which shall be the Cumulative Return;

Debtor Party: has the meaning set forth in Section 6.2 of this Loan Agreement.
**Default:** means any Event of Default and any event or condition which with the passage of time or giving of notice, or both, would become an Event of Default, including the filing against the Borrower or any other Obligor of a petition commencing an involuntary case under the Bankruptcy Code;

**Default Rate:** a rate equal to 18% per annum;

**Default Rate Period:** a period of time commencing on the date that an Event of Default has occurred and ending on the date that such Event of Default is cured or waived;

**Effective Date:** __________, 2002;

**Employee Benefit Plan:** any employee benefit plan within the meaning of Section 3(3) of ERISA which (i) is maintained for employees of Borrower or any ERISA Affiliate, or (ii) has at any time within the preceding six years been maintained for the employees of Borrower or any current or former ERISA Affiliate;

**Environmental Laws:** any and all federal, state and local laws that relate to or impose liability or standards of conduct concerning public or occupational health and safety or protection of the environment, as now or hereafter in effect and as have been or hereafter may be amended or reauthorized, including, without limitation, the Comprehensive Environmental Response, Compensation and Liability Act (42 U.S.C. Section 9601 et seq.), the Hazardous Materials Transportation Act (42 U.S.C. Section 1802 et seq.), the Resource Conservation and Recovery Act (42 U.S.C. Section 6901 et seq.), the Federal Water Pollution Control Act (33 U.S.C. Section 1251 et seq.), the Toxic Substances Control Act (15 U.S.C. Section 2601 et seq.), the Clean Air Act (42 U.S.C. Section 7901 et seq.), the National Environmental Policy Act (42 U.S.C. Section 4231, et seq.), the Refuse Act (33 U.S.C. Section 407, et seq.), the Safe Drinking Water Act (42 U.S.C. Section 300(f) et seq.), the Occupational Safety and Health Act (29 U.S.C. Section 651 et seq.), and all rules, regulations, codes, ordinances and guidance documents promulgated or published thereunder, and the provisions of any licenses, permits, orders and decrees issued pursuant to any of the foregoing;

**ERISA:** the Employee Retirement Income Security Act of 1974, as amended, any successor statute thereto, and the rules and regulations issued thereunder, as in effect from time to time;

**ERISA Affiliate:** any Person who is a member of a group which is under common control with any Borrower, who together with any Borrower is treated as a single employer within the meaning of Section 414(b), (c) and (m) of the Code;

**Event of Default:** any of the Events of Default set forth in Section 7.1 of this Loan Agreement;

**Excess Amount:** has the meaning set forth in Section 5.18 of this Loan Agreement;

**Facility Fee:** means two percent (2%) of the amount of the Loan;

**Funding Date:** the date of the disbursement of the Advance;
GAAP: generally accepted accounting principles as in effect from time to time, which shall include but shall not be limited to the official interpretations thereof by the Financial Accounting Standards Board or any successor thereto;

Good Funds: United States Dollars available in Federal funds to Lender at or before 2:00 p.m., New York time, on a Business Day;

Governmental Body: any foreign, federal, state, municipal or other government or any department, commission, board, bureau, agency, public authority or instrumentality thereof or any court or arbitrator;

Guarantee: with respect to Obligors (or other specified Person):

(a) any guarantee by Obligors (or such specified Person) of the payment or performance of, or any contingent obligation by Obligors (or such specified Person), in respect of any Indebtedness or other obligation of any primary obligor;

(b) any other arrangement whereby credit is extended to a primary obligor on the basis of any promise or undertaking of Obligors (or such specified Person), including any binding “comfort letter” or “keep well arrangement” written by Obligors (or such specified Person), to a creditor or prospective creditor of such primary obligor, to (i) pay the Indebtedness of such primary obligor, (ii) purchase an obligation owned by such primary obligor, (iii) pay for the purchase or lease of assets or services regardless of the actual delivery thereof, or (iv) maintain the capital, working capital, solvency or general financial condition of such primary obligor;

(c) any liability of Obligors (or such specified Person), as a general partner of a partnership in respect of Indebtedness or other obligations of such partnership;

(d) any liability of Obligors (or such specified Person) as a joint venturer of a joint venture in respect of Indebtedness or other obligations of such joint venture;

(e) any liability of Obligors (or such specified Person) with respect to the tax liability of others as a member of a group (other than a group consisting solely of Borrower and its Subsidiaries) that is consolidated for tax purposes; and

(f) reimbursement obligations, whether contingent or matured, of Obligors (or such specified Person) with respect to letters of credit, bankers acceptances, surety bonds, other financial guarantees and interest rate protection agreements, in each case whether or not any of the foregoing are reflected on the balance sheet of Obligors (or such specified Person) or in a footnote thereto; provided, however, that the term “Guarantee” shall not include endorsements for collection or deposit in the ordinary course of business. The amount of any Guarantee and the amount of Indebtedness resulting from such Guarantee shall be the maximum amount that the guarantor may become obligated to pay in respect of the obligations (whether or not such obligations are outstanding at the time of computation);
Hazardous Materials: any hazardous, toxic, dangerous or other waste, substance or material defined as such in, regulated by or for purposes of any Environmental Law;

Holders: when used with respect to Senior Debt, means Bank and all successors, assigns and participants having an interest in the Senior Debt at the date hereof or hereafter or as otherwise memorialized in the Bank Loan Agreement; when used with respect to Borrower’s Obligations to Lender, means the Lenders, their successors and assigns, including Assignees;

Incipient Default: any event or condition which, with the giving of notice or the lapse of time, or both, would become an Event of Default;

Indebtedness: all liabilities, obligations and reserves, contingent or otherwise, which, in accordance with GAAP, would be reflected as a liability on a balance sheet or would be required to be disclosed in a financial statement, including, without duplication: (i) Indebtedness for Borrowed Money, (ii) obligations secured by any Lien upon Property, (iii) guaranties, letters of credit and other contingent obligations, and (iv) liabilities in respect of unfunded vested benefits under any Pension Plan or in respect of withdrawal liabilities incurred under ERISA by Borrower or any ERISA Affiliate to any Multiemployer Plan;

Indebtedness for Borrowed Money: without duplication, all Indebtedness (i) in respect of money borrowed, (ii) evidenced by a note, debenture or other like written obligation to pay money (including, without limitation, all of Borrowers’ Obligations and Permitted Senior Indebtedness), (iii) in respect of rent or hire of Property under Capitalized Leases or for the deferred purchase price of Property, (iv) in respect of obligations under conditional sales or other title retention agreements, and (v) all guaranties of any or all of the foregoing;

Interest Rate: the rate of thirteen and one-quarter percent (13.25%) per annum, simple interest;

Key Man Life Insurance: the life insurance on the lives of _________ and _________ required pursuant to Subsection 4.11.1;

Leases: the leases of real property described in Exhibit 3.4.2;

Leasehold Property: any real estate which is the subject of a Lease under which any Obligor is the lessee;

Lender: Investor;

Lenders: each of the Persons listed as lenders on the signature page hereto, including _________ in its capacity as a lender and such other Persons who may from time to time own a Percentage Interest in the Borrower’s Obligations under this Loan Agreement;

Lien: any mortgage, pledge, assignment, lien, charge, encumbrance or security interest of any kind, or the interest of a vendor or lessor under any conditional sale agreement, Capitalized Lease or other title retention agreement;
Liquidity Event: (i) a Change in Control of Borrower, (ii) an Acquisition of Borrower, or (iii) a liquidation or dissolution of Borrower;

Loan: the loan to be made by Lender to Borrower in the maximum principal amount of $30,000,000, subject to the terms and conditions of this Loan Agreement;

Loan Agreement: this Subordinated Loan Agreement dated September ____, 2002;

Loan Assignment: the sale, transfer or assignment by a Lender of (i) any portion of Lender's interest in Borrower's Obligations, and (ii) any of Lender's other rights under any of the Loan Instruments;

Loan Instruments:
(i) Loan Agreement;
(ii) Note;
(iii) Registration Rights Agreement;
(iv) Warrant; and
(v) other instruments and documents as Lender reasonably may require in connection with the transactions contemplated by this Loan Agreement;

Management Team: means the executive officers and directors of the Obligors as of the date of Closing;

Material Adverse Effect: (i) a material adverse effect upon the business, operations, Property or financial condition of Borrower, or (ii) a material impairment of the ability of any Obligor to perform its obligations under any Loan Instrument;

Multiemployer Plan: any multiemployer plan as defined pursuant to Section 3(37) of ERISA to which Borrower or any ERISA Affiliate makes, or accrues an obligation to make contributions, or has made, or been obligated to make, contributions within the preceding six years;

Non-Payment Default: has the meaning set forth in Section 6.3.1 of this Loan Agreement;

Non-Recourse Indebtedness: Indebtedness of such Person for which (i) the sole legal recourse for collection of principal and interest on such Indebtedness is against the specific property identified in the instruments evidencing or securing such Indebtedness and such property was acquired with the proceeds of such Indebtedness or such Indebtedness was incurred within 90 days after the acquisition of such property, and (ii) no other assets of such Person may be realized upon in collection of principal or interest on such Indebtedness. Indebtedness which is otherwise Non-Recourse Indebtedness will not lose its character as Non-Recourse Indebtedness because there is recourse to the Borrower or any other Person for (i) environmental warranties and indemnities, or (ii) indemnities for and liabilities arising from fraud, misrepresentation, misapplication or non-payment of rents, prof-
its, insurance and condemnation proceeds and other sums actually received by the Borrower from secured assets to be paid to the lender, waste and mechanics’ liens;

**Note:** a promissory note in form and substance satisfactory to Lender in the principal amount of $25,000,000 executed and delivered by Borrower to Lender to evidence the Loan, subordinated to the Permitted Senior Indebtedness pursuant to the Subordination Agreement;

**Obligor:** any of the Obligors;

**Obligors:** collectively, Borrower and the Subsidiaries;

**Parties:** collectively, Lender and the Borrower;

**Payment Blockage Period:** has the meaning set forth in Section 6.3.1 of this Loan Agreement;

**Payment Default:** has the meaning set forth in Section 6.3.1 of this Loan Agreement;

**PBGC:** the Pension Benefit Guaranty Corporation or any Governmental Body succeeding to the functions thereof;

**Pension Plan:** any Employee Benefit Plan, other than a Multiemployer Plan, which is subject to the provisions of Part 3 of Title I of ERISA, Title IV of ERISA, or Section 412 of the Code and which (i) is maintained for employees of Borrower or any ERISA Affiliate, or (ii) has at any time within the preceding six years been maintained for the employees of Borrower or any of its current or former ERISA Affiliates;

**Percentage Interest:** with respect to any Lenders, the Commitment of such Lender with respect to the respective portion of the Borrower’s Obligations under this Loan Agreement. For purposes of determining votes of consents by the Lenders, the Percentage Interest of any Lender shall be computed based upon the ratio that the respective Commitments of such Lender bears to the total Commitments of all Lenders as from time to time in effect and reflected in the Register;

**Permitted Liens:** any of the following Liens:

(a) the Permitted Senior Indebtedness Liens;

(b) Liens for taxes or assessments and similar charges, which either are (A) not delinquent, or (B) being contested diligently and in good faith by appropriate proceedings, and as to which the applicable Obligor has set aside reserves on its books which are satisfactory to Lender;

(c) statutory Liens, such as mechanic’s, materialman’s, warehouseman’s, carrier’s or other like Liens, incurred in good faith in the ordinary course of business, provided that the underlying obligations relating to such Liens are paid in the ordinary course of business, or are being contested diligently and in good faith by appropriate proceedings and as to which the applicable Obligor has set aside reserves on its books reasonably satisfactory to Lender, or the payment of which obligations are otherwise secured in a manner reasonably satisfactory to Lender;
(d) zoning ordinances, easements, licenses, reservations, provisions, covenants, conditions, waivers or restrictions on the use of Property and other title exceptions, in each case, that are reasonably acceptable to Lender;

(e) Liens in respect of judgments or awards with respect to which no Event of Default would exist pursuant to Subsection 7.1.6; and

(f) Liens to secure payment of insurance premiums (A) to be paid in accordance with applicable laws in the ordinary course of business relating to payment of worker’s compensation, or (B) that are required for the participation in any fund in connection with worker’s compensation, unemployment insurance, pensions or other social security programs;

Permitted Senior Indebtedness: Indebtedness, other than Borrower’s Obligations to Lender, incurred by any Obligor (A) from Bank pursuant to the Bank Loan Agreement, and any amendments, extensions, substitutions or refinancings therefor, or (B) to purchase tangible personal property or Indebtedness incurred to lease tangible personal property pursuant to Capitalized Leases, the purchase price of which shall not exceed the fair market value of such property;

Permitted Senior Indebtedness Liens: Liens that secure Permitted Senior Indebtedness;

Person: any individual, firm, corporation, limited liability company, business enterprise, trust, association, joint venture, partnership, Governmental Body or other entity, whether acting in an individual, fiduciary or other capacity;

PIK: means interest payable in kind equal to two percent (2%) per annum, simple interest;

Prepayment Premium: has the meaning set forth in Section 2.5.2 of this Loan Agreement;

Principal Balance: the unpaid principal balance of the Loan or any specified portion thereof outstanding from time to time;

Prior Year: has the meaning set forth in Section 5.18 of this Loan Agreement;

Property: all types of real, personal or mixed property and all types of tangible or intangible property;

Qualified Depository: a member bank of the Federal Reserve System having a combined capital and surplus of at least $100,000,000;

Register: a register maintained by the Agent at its offices for the recordation of the names and addresses of the Lenders which assume rights and obligations pursuant to the assignment provisions of Section 9.12 of this Loan Agreement;

Registration Rights Agreement: the registration rights agreement between Borrower and Lender relating to shares of common stock of Borrower issuable on exercise of the Warrant and dated as of the date hereof;
Regulation S-X: the regulatory scheme governing accounting disclosure adopted under the Securities Act of 1933, as amended and known as Regulation S-X;

Required Banks: has the meaning set forth in Section 6.3.1 of this Loan Agreement;

Required Senior Debt Holders: has the meaning set forth in Section 6.3.1 of this Loan Agreement;

Senior Agent: has the meaning set forth in Section 6.8 of this Loan Agreement;

Senior Debt or Senior Indebtedness: means all Indebtedness (present or future) created, incurred, assumed or guaranteed by the Borrower and its Subsidiaries (including all renewals, extensions, modifications, refundings or refinancings thereof), unless the instrument under which such Indebtedness is created, incurred, assumed or guaranteed provides that such Indebtedness is not senior or superior in right of payment to the Borrower’s Obligations to Lender. Notwithstanding anything to the contrary in the foregoing, Senior Debt and Senior Indebtedness shall not include (i) any indebtedness of the Borrower to any of its Subsidiaries, (ii) any trade payables of any Obligor, or (iii) guarantees by any Obligor of Indebtedness (a) outstanding at the date hereof, or (b) which may be outstanding in the future, except that Senior Debt or Senior Indebtedness shall include any present and future guarantees that provide by their terms that they constitute Senior Debt or Senior Indebtedness;

Senior Indebtedness Due Bank: all of Borrower’s Obligations as defined in the Bank Loan Agreement;

Subordination Agreement: that certain Lender Subordination Agreement among Borrower, Lender and Bank dated as of September ____, 2002, attached hereto as Exhibit 6.1, as the same may be amended, restated, supplemented or otherwise modified pursuant to the terms thereof;

Subsidiary: any Person of which Borrower (or such specified Person) shall at the time, directly or indirectly through one or more of its Subsidiaries, (a) own at least 50% of the outstanding capital stock (or other shares of beneficial interest) entitled to vote generally, (b) hold at least 50% of the partnership, joint venture or similar interest, or (c) be a general partner or joint venturer;

Tangible Assets: means total assets less intangible assets as calculated in accordance with GAAP;

Termination Event: (i) a “Reportable Event” described in Section 4043 of ERISA and the regulations issued thereunder; or (ii) the withdrawal of Borrower or any ERISA Affiliate from a Pension Plan during a plan year in which it was a “substantial employer” as defined in Section 4001(a) (2); or (iii) the termination of a Pension Plan, the filing of a notice of intent to terminate a Pension Plan or the treatment of a Pension Plan amendment as a termination under Section 4041 of ERISA; or (iv) the institution of proceedings to terminate, or the appointment of a trustee with respect to, any Pension Plan by the PBGC; or (v) any other event or condition which would constitute grounds under Section 4042(a) of ERISA for
the termination of, or the appointment of a trustee to administer, any Pension Plan; or (vi) the partial or complete withdrawal of Borrower or any ERISA Affiliate from a Multiemployer Plan; or (vii) the imposition of a lien pursuant to Section 412 of the Code or Section 302 of ERISA; or (viii) any event or condition which results in the reorganization or insolvency of a Multiemployer Plan under Sections 4241 or 4245 of ERISA; or (ix) any event or condition which results in the termination of a Multiemployer Plan under Section 4041A of ERISA or the institution by the PBGC of proceedings to terminate a Multiemployer Plan under Section 4042 of ERISA;

**Total Debt:** as of any applicable date, the sum of Borrower's Obligations as of such date;

**United States Dollars:** means such currency of the United States of America as at the time shall be legal tender therein for the payment of public and private debts. References to "Dollars" or "$" mean United States Dollars;

**Warrant:** the warrant issued by Borrower to Lender entitling Lender to purchase shares of Common Stock, dated as of the date hereof; and

**Warrant Shares:** the shares of Common Stock issuable to Lender on exercise of the Warrant, including any shares of Common Stock issued pursuant to the anti-dilution provisions of such Warrant.

1.2 **Time Periods.** In this Loan Agreement and the other Loan Instruments, in the computation of periods of time from a specified date to a later specified date, (i) the word "from" means "from and including," (ii) the words "to" and "until" each mean "to, but excluding," and (iii) the words "through," "end of" and "expiration" each mean "through and including." Unless otherwise specified, all references in this Loan Agreement and the other Loan Instruments to (i) a "month" shall be deemed to refer to a calendar month, (ii) a "quarter" shall be deemed to refer to a calendar quarter, and (iii) a "year" shall be deemed to refer to a calendar year.

1.3 **Accounting Terms and Determinations.** All accounting terms not specifically defined herein shall be construed, all accounting determinations hereunder shall be made and all financial statements required to be delivered pursuant hereto shall be prepared in accordance with GAAP as in effect at the time of such interpretation, determination or preparation, as applicable, unless otherwise required by Regulation S-X, associated Staff Accounting Bulletins and concurred to by the Accountants. In the event that any "Accounting Changes" (as hereinafter defined) occur and such changes result in a change in the method of calculation of financial covenants, standards or terms contained in this Loan Agreement then Borrower and Lender agree to enter into negotiations to amend such provisions of this Loan Agreement so as to reflect such Accounting Changes with the desired result that the criteria for evaluating the financial condition of Borrower shall be the same after such Accounting Changes as if such Accounting Changes had not been made. For purposes hereof, "Accounting Changes" shall mean (i) changes in generally accepted accounting principles required by the promulgation of any rule, regulation, pronouncement or opinion by the Financial
Accounting Standards Board of the American Institute of Certified Public Accountants (or any successor thereto) or other appropriate authoritative body, and (ii) changes in accounting principles as approved by the Accountants.

1.4 References. All references contained in (i) this Loan Agreement to "Article," "Section," "Subsection," "Subparagraph," "Clause" or "Exhibit," unless otherwise indicated, shall be deemed to refer to an Article, Section, Subsection, Subparagraph, Clause or Exhibit, as applicable, of this Loan Agreement, (ii) to any Loan Instrument at any given time shall be to such Loan Instrument as the same shall have been amended, supplemented, restated or otherwise modified as of such time, and (iii) to "Lender" shall be deemed to refer to "Lenders" if at or subsequent to the Closing there shall be multiple Lenders in the Register.

1.5 Lender's Discretion. Whenever the terms "satisfactory to Lender," "determined by Lender," "acceptable to Lender," "Lender shall request," "at the option or election of Lender," or similar terms are used in the Loan Instruments, except as otherwise specifically provided therein, such terms shall mean satisfactory to, at the election or option of, determined by, acceptable to or requested by Lender, as applicable, in its sole and unlimited discretion.

1.6 Borrower's Knowledge. Any statements, representations or warranties that are based upon the best knowledge of Borrower or an officer thereof shall be deemed to have been made after due inquiry by Borrower or an officer, as applicable, with respect to the matter in question.

1.7 Interpretation. Unless the context of this Loan Agreement otherwise requires, (i) words in the singular include the plural, and in the plural include the singular, (ii) provisions apply to successive events and transactions, and (iii) "or" is not exclusive.

1.8 First Use of Defined Terms. The following capitalized terms, which may be used in more than one Section or other location of this Loan Agreement, are first used in the following Sections:

<table>
<thead>
<tr>
<th>Term</th>
<th>Section or other Location</th>
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<tbody>
<tr>
<td>BORROWER</td>
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1.9 Exhibits. The following tabulates the exhibits to this Loan Agreement.

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<th>Exhibit</th>
<th>Description</th>
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<td>3.4.2</td>
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<td>Subordination Agreement</td>
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<tr>
<td>9.12.1</td>
<td>Assignment and Acceptance</td>
</tr>
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ARTICLE II

LOAN AND TERMS OF PAYMENT

2.1 Advance.

2.1.1 Amount and Disbursement. The Advance will be made by Lender to Borrower in the principal amount of $30,000,000, provided that all of the terms and conditions set forth in Article X have been satisfied.

2.1.2 Use of Proceeds. The proceeds of the Advance shall be used to pay _____ and reasonable fees and expenses related to the transaction described in this Loan Agreement.

2.2 Note. The Loan shall be evidenced by the Note.

2.3 Interest.

2.3.1 Interest Rate. Except during a Default Rate Period as provided in Section 2.6, the Principal Balance outstanding from time to time shall bear interest at the Interest Rate. Interest shall accrue from the date of each Advance on the principal balance thereof.

2.3.2 Interest Computation. Interest shall be computed on the basis of a year consisting of 360 days and charged for the actual number of days during the period for which interest is being charged. In computing interest, the Principal Balance on the date of the funding of an Advance shall include the amount of the Advance and the Principal Balance on the date of payment of any amount due hereunder and shall exclude the amount paid.

2.3.3 Payment in Kind. The Principal Balance outstanding from time to time shall be increased by the PIK. The PIK shall be accrued on a quarterly basis in arrears.

2.4 Principal and Interest Payments.
2.4.1 **Interest.** Interest payments calculated at the Interest Rate (or the Default Rate, if applicable) on the outstanding Principal Balance shall be payable quarterly in arrears on the first Business Day of each three month period beginning with January 1, 2003, subject to the provisions of the Subordination Agreement.

2.4.2 **Principal.** The Principal Balance shall be payable in four equal semi-annual payments commencing October __, 2006 and thereafter on April __, 2007, October __, 2007 and April __, 2008 subject to the provisions of the Subordination Agreement and unless earlier prepaid.

2.5 **Prepayments.**

2.5.1 **Voluntary Prepayment of Loan.** Borrower may, at its sole option at any time upon thirty (30) days prior written notice and after three years from the date hereof, prepay this Note without penalty, in whole or in part (in multiples of $1,000,000), together with all accrued and unpaid interest on the Principal Balance so prepaid to the date of such prepayment. Additionally, Borrower may, at its sole option upon thirty (30) days prior written notice and after one year from the date hereof and prior to three years from the date hereof, prepay this Note, at a prepayment price equal to one hundred six percent (106%) of the Principal Balance, in whole or in part (in multiples of $1,000,000), together with accrued and unpaid interest on the Principal Balance so prepaid to the date of such prepayment.

2.5.2 **Prepayment at Lender's Option.** At the Lender's option upon the occurrence of a Liquidity Event then, subject to the provisions of the Subordination Agreement, all of Borrower's Obligations to Lender shall become immediately due and payable at the sole discretion of the Lender. If the Lender elects to exercise its right to declare all of Borrower's Obligations to Lender due and payable, such election shall be evidenced by three Business Days' prior written notice from Lender to Borrower. Subject to the provisions of the Subordination Agreement, Borrower shall upon receipt of such notice pay to Lender the outstanding Principal Balance, together with accrued and unpaid interest on the Principal Balance, together with a prepayment premium (the "Prepayment Premium") calculated as a percentage of the then outstanding Principal Balance prepaid in accordance with the following schedule:

<table>
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<th>Prepayment Date</th>
<th>Prepayment Premium Calculated on the Aggregate Principal Balance Prepaid</th>
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<tr>
<td>January __, 2003 to January __, 2004</td>
<td>5%</td>
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<tr>
<td>January __, 2004 to January __, 2005</td>
<td>4%</td>
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<tr>
<td>January __, 2005 to January __, 2006</td>
<td>3%</td>
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<tr>
<td>January __, 2006 to January __, 2007</td>
<td>0%</td>
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</tbody>
</table>
Notwithstanding the foregoing language concerning the Prepayment Premium payable by Borrower to Lender, the Lender shall waive, and release Borrower from any obligation for, the Prepayment Premium in the event that the Cumulative Return to Lender has exceeded two times the original Principal Balance of the Note.

2.6 **Default Rate Period.** During a Default Rate Period, (i) Borrower’s Obligations shall bear interest at the Default Rate, and (ii) all payments received by Lender shall be applied in accordance with Section 7.4.

2.7 **Method of Payment.** Borrower shall remit all amounts due hereunder to Lender in Good Funds, on the due date of such payment, for application to Borrower’s Obligations in the following order of priority: (i) first, to the payment of all Borrower’s Obligations then due and payable other than the Principal Balance and accrued and unpaid interest thereon, and (ii) second, to the payment of accrued and unpaid interest then due and payable on the Principal Balance, and (iii) if applicable, towards payment of the Principal Balance. All payments to be made pursuant to the Loan Instruments by Borrower to Lender shall be made by wire transfer of Good Funds to the account of _______________, ABA # ______________, credit the account of _______________, Account No. ______________, or to such other account to which Lender shall have given five Business Days prior written notice.

**ARTICLE III**

**REPRESENTATIONS AND WARRANTIES**

Borrower represents and warrants to Lender as follows:

3.1 **Existence and Power.** Borrower and each of the Subsidiaries is a corporation duly formed and validly existing under the laws of its respective jurisdiction. Each Obligor is in good standing and qualified to transact business in each jurisdiction in which the failure so to qualify could have a Material Adverse Effect. Each Obligor has all requisite power and authority to own its Property and to carry on its business as now conducted and as proposed to be conducted following the Effective Date.

3.2 **Authority.** Each Obligor has full power and authority to enter into, execute, deliver and carry out the terms of the Loan Instruments to which it is a party and to incur the obligations provided for therein, all of which have been duly authorized by all proper and necessary action and are not prohibited by the organizational instruments of any such Obligor.

3.3 **Binding Agreements.** This Loan Agreement and the other Loan Instruments, when executed and delivered, will constitute the valid and legally binding obligations of each Obligor to the extent such Obligor is a party thereto, enforceable against such Obligor in accordance with their respective terms, except as such enforceability may be limited by (i) applicable bankruptcy, insolvency, reorganization, moratorium or similar laws now or hereafter in effect affecting the
enforcement of creditors’ rights generally, and (ii) equitable principles (whether or not any action to enforce such document is brought at law or in equity).

3.4 Business and Property of Borrowers.

3.4.1 Business and Property. Each Obligor is the owner of all Property and the holder of all licenses necessary to conduct Borrower’s Business in the places where it is now conducted.

3.4.2 Leases. There is set forth in Exhibit 3.4.2 a list of all Leases of real property under which any Obligor is the lessee, together with a complete and accurate address and legal description of each such parcel of Leasehold Property and the current landlord under each Lease. Each Lease is in full force and effect, there has been no material default in the performance of any of its terms or conditions by any party thereto, and no claim of default has been asserted with respect thereto. To the best knowledge of Borrower, the present and contemplated use of the Leasehold Property is in material compliance with all applicable zoning ordinances and regulations and other laws and regulations.

3.4.3 Real Estate. Borrower owns no real property.

3.4.4 Operation and Maintenance of Equipment. To the best knowledge of Borrower, no Person owning or operating any equipment necessary for the operation of Borrower’s Business has used, operated or maintained the same in a manner which now or hereafter could result in the cancellation or termination of any material rights of any Obligor to use or make use of the same or which could result in any material liability of any Obligor for damages in connection therewith. All of the equipment and other tangible personal property owned by each Obligor on the Effective Date is, in all material respects, in good operating condition and repair (subject to normal wear and tear) and has to the best knowledge of Borrower, been used, operated and maintained in substantial compliance with all applicable laws, rules and regulations.

3.4.5 Title to Property; Liens. On the Effective Date each Obligor shall have (i) good and marketable title to all of its Property, except the portion thereof consisting of a leasehold estate, and (ii) a valid leasehold estate in each portion of its Property which consists of a leasehold estate. To the best knowledge of Borrower, upon the Effective Date, all of such Property was free and clear of all Liens, except Permitted Liens.

3.5 Litigation. There is set forth in Exhibit 3.5 a description of all actions and suits, arbitration proceedings and claims pending or, to the best knowledge of Borrower, threatened against any Obligor or maintained by any Obligor at law or in equity or before any Governmental Body. None of the matters set forth in such Exhibit 3.5, if adversely determined, could have a Material Adverse Effect.

3.6 Defaults in Other Agreements: Consents; Conflicting Agreements. No Obligor is in default under any agreement to which such Obligor is a party or by which such Obligor or any of the Property of such Obligor is bound, the effect of which default could have a Material Adverse Effect. No authorization, consent, approval or other action by, and no notice to or filing with, any Governmental
Body or any other Person which has not already been obtained, taken or filed, as applicable, is required (i) for the due execution, delivery or performance by Borrower of the Loan Instruments, or (ii) as a condition to the validity or enforceability of any of the Loan Instruments or any of the transactions contemplated thereby. To the knowledge of Borrower, no provision of any material mortgage, indenture, contract, agreement, statute, rule, regulation, judgment, decree or order binding on any Obligor or affecting the Property of any Obligor conflicts with, or requires any consent which has not already been obtained under, or would in any way prevent the execution, delivery or performance of the terms of any of the Loan Instruments. The execution, delivery or performance of the terms of the Loan Instruments will not constitute a default under, or result in the creation or imposition of, or obligation to create, any Lien upon the Property of the Obligors pursuant to the terms of any such material mortgage, indenture, contract or agreement.

3.7 Taxes. Each Obligor has filed all tax returns required to be filed, and has paid, or made adequate provision for the payment of, all taxes shown to be due and payable on such returns or in any assessments made against any such Person, and no tax Liens have been filed and no claims are being asserted in respect of such taxes which are required by GAAP to be reflected in the financial statements of Borrower and are not so reflected therein. As of the time of filing, the tax returns of each Obligor were complete in all material respects and do not contain a disclosure statement under Code Section 6662. The charges, accruals and reserves on the books of Borrower with respect to all federal, state, local and other taxes are considered by the management of Obligor to be adequate, and there is no unpaid assessment known to any Obligor which is or might be due and payable by any Obligor or create a Lien against any Obligor's Property, except such assessments as are being contested in good faith and by appropriate proceedings diligently conducted, and for which adequate reserves have been set aside in accordance with GAAP. None of the tax returns of any Obligor at the Effective Date are under audit and no Obligor has received notice at or prior to the Effective Date of a proposed audit.

3.8 Compliance with Applicable Laws. No Obligor is in default in respect of any judgment, order, writ, injunction, decree or decision of any Governmental Body, which default would have a Material Adverse Effect. Except as otherwise provided herein, each Obligor is in compliance in all material respects with all applicable statutes and regulations, including, without limitation, all Environmental Laws, ERISA, ADA and all laws and regulations relating to unfair labor practices, equal employment opportunity and employee safety, of all Governmental Bodies, a violation of which could have a Material Adverse Effect. No material condemnation, eminent domain or expropriation has been commenced or, to the best knowledge of Borrower, threatened against the Property that the Obligors own on the Effective Date.

3.9 Patents, Trademarks, Franchises, Agreements. Upon the Effective Date, the Obligors will own, possess or have the right to use all material patents, trademarks, service marks, tradenames, copyrights, franchises and rights with respect thereto, necessary for the conduct of Borrower's Business as proposed to
be conducted after the Effective Date, without any known conflict with the rights of others and, in each case, free of any Liens.

3.10 **Environmental Matters.** Each Obligor is in compliance with all applicable Environmental Laws and no portion of the Leasehold Property has been used as a land fill. There currently are not any known Hazardous Materials generated, manufactured, released, stored, buried or deposited over, beneath, in or on (or used in the construction and/or renovation of) the Leasehold Property in violation of applicable Environmental Laws which could have a Material Adverse Effect. The Borrower has submitted to Lender complete and correct copies of all material environmental investigations, assessments, studies, audits or reviews conducted of which any of the Obligors has knowledge with respect to any Property or facility now or previously owned, operated, used, controlled or leased by any such Obligor including, without limitation, those relating to compliance with or liability under any Environmental Laws.

3.11 **Other Indebtedness.** On the Effective Date, no Obligor had any Indebtedness for Borrowed Money, except (i) Borrower’s Obligations, (ii) Permitted Senior Indebtedness permitted to exist as of the Effective Date pursuant to this Loan Agreement, and (iii) Non-Recourse Indebtedness.

3.12 **No Misrepresentation.** Neither this Loan Agreement nor any other Loan Instrument, certificate, information or report furnished or to be furnished by or on behalf of Borrower to Lender in connection with any of the transactions contemplated hereby or thereby, contains or will contain a misstatement of material fact, or omits or will omit to state a material fact required to be stated in order to make the statements contained herein or therein, taken as a whole, not misleading in the light of the circumstances under which such statements were made. There is no fact, other than information known to the public generally, known to or reasonably foreseen by Borrower after diligent inquiry, that would be expected to have a Material Adverse Effect that has not expressly been disclosed to Lender in writing.

3.13 **Employee Benefit Plans.**

3.13.1 **No Other Plans.** Neither Borrower nor any ERISA Affiliate maintains or contributes to, or has any obligation under, any Employee Benefit Plan other than those identified on Exhibit 3.13.1.

3.13.2 **ERISA and Code Compliance and Liability.** Borrower and each ERISA Affiliate is in compliance with all applicable provisions of ERISA with respect to all Employee Benefit Plans except where failure to comply would not result in a material liability to Borrower and except for any required amendments for which the remedial amendment period as defined in Section 401(b) of the Code has not yet expired. Each Employee Benefit Plan that is intended to be qualified under Section 401(a) of the Code has been determined by the Internal Revenue Service to be so qualified, and each trust related to such plan has been determined to be exempt under Section 501(a) of the Code, except for any amendments for which the remedial amendment period as defined in Section 401(b) of the Code has not yet expired. No material liability
has been incurred by Borrower or any ERISA Affiliate which remains unsatisfied for any taxes or penalties with respect to any Employee Benefit Plan or any Multiemployer Plan.

3.13.3 **Funding.** No Pension Plan has been terminated, nor has any accumulated funding deficiency (as defined in Section 412 of the Code) been insured (without regard to any waiver granted under Section 412 of the Code), nor has any funding waiver from the Internal Revenue Service been received or requested with respect to any Pension Plan, nor has Borrower or any ERISA Affiliate failed to make any contributions or to pay any amounts due and owing as required by Section 412 of the Code, Section 302 of ERISA or the terms of any Pension Plan prior to the due dates of such contributions under Section 412 of the Code or Section 302 of ERISA, nor has there been any event requiring any disclosure under Section 4041(c) (3) (C), 4063(a) or 4068 of ERISA with respect to any Pension Plan.

3.13.4 **Prohibited Transactions and Payments.** Neither any Borrower nor any ERISA Affiliate has: (i) engaged in a nonexempt "prohibited transaction" as such term is defined in Section 406 of ERISA or Section 4975 of the Code; (ii) incurred any liability to the PBGC which remains outstanding other than the payment of premiums and there are no premium payments which are due and unpaid; (iii) failed to make a required contribution or payment to a Multiemployer Plan; or (iv) failed to make a required installment or other required payment under Section 412 of the Code.

3.13.5 **No Termination Event.** No Termination Event has occurred or is reasonably expected to occur.

3.13.6 **ERISA Litigation.** No material proceeding, claim, lawsuit and/or investigation is existing or, to the best knowledge of Borrower, threatened concerning or involving any (i) employee welfare benefit plan (as defined in Section 3(1) of ERISA) currently maintained or contributed to by Borrower, or any ERISA Affiliate, (ii) Pension Plan, or (iii) Multiemployer Plan.

3.14 **Employee Matters.**

3.14.1 **Collective Bargaining Agreements; Grievances.** (i) None of the employees of any Obligor is subject to any collective bargaining agreement, (ii) no petition for certification or union election is pending with respect to the employees of any Obligor and no union or collective bargaining unit has sought such certification or recognition with respect to the employees of any Obligor, and (iii) there are no strikes, slowdowns, work stoppages, unfair labor practice complaints, grievances, arbitration proceedings or controversies pending or, to the best knowledge of Borrower, threatened against any Obligor by any Obligor's employees, other than employee grievances or controversies arising in the ordinary course of business that could not in the aggregate be expected to have a Material Adverse Effect.

3.14.2 **Claims Relating to Employment.** Neither any Obligor nor, to Borrower's best knowledge, any officer, stockholder or employee of any Obligor, is
subject to any employment agreement or noncompetition agreement with any former employer or any other Person which agreement would have a Material Adverse Effect due to (i) any information which such Obligor would be prohibited from using under the terms of such agreement, or (ii) any legal considerations relating to unfair competition, trade secrets or proprietary information.

3.15 Burdensome Obligations. After giving effect to the transactions contemplated by the Loan Instruments, (i) no Obligor (A) will be a party to or be bound by any franchise, agreement, deed, lease or other instrument, or be subject to any restriction, which is so unusual or burdensome so as to cause, in the foreseeable future, a Material Adverse Effect, and (B) intends to incur, or believes that it will incur, debts beyond its ability to pay such debts as they become due, and (ii) each Obligor (A) owns and will own Property, the fair salable value of which is (I) greater than the total amount of its liabilities (including contingent liabilities), and (II) greater than the amount that will be required to pay the probable liabilities of its then existing debts as they become absolute and matured, and (B) has and will have capital that is not unreasonably small in relation to its business as presently conducted and as proposed to be conducted. No Obligor presently anticipates that future expenditures needed to meet the provisions of federal or state statutes, orders, rules or regulations will be so burdensome so as to have a Material Adverse Effect.

3.16 Financial Statements. The Borrower has previously furnished to the Lender copies of the following:

(a) the audited Consolidated balance sheets of Borrower and its Subsidiaries as at December 31, 2000 and 2001 and the audited Consolidated statements of income, of changes in stockholders' equity and of cash flows of Borrower and its Subsidiaries for the fiscal years then ended;

(b) the unaudited Consolidated balance sheet of Borrower and its Subsidiaries as at _________ and the unaudited Consolidated statements of income and of cash flows of Borrower and its Subsidiaries for the portion of the fiscal year then ended.

The audited Consolidated financial statements (including the notes thereto) referred to clause (a) above were prepared in accordance with GAAP and fairly present in all material respects the financial position of the Obligors on a Consolidated basis at the respective dates thereof and the results of their operations for the periods covered thereby. The unaudited Consolidated financial statements referred to in clause (b) above were prepared in accordance with GAAP and fairly present in all material respects the financial position of the Obligors on a Consolidated basis at the respective dates thereof and the results of their operations for the periods covered thereby, subject to normal year-end audit adjustments and the addition of footnotes in the case of interim financial statements. None of the Obligors have any known contingent liability material to the Obligors on a Consolidated basis which (if required by GAAP to be reflected on the balance sheets or in the notes to the financial statements) is not reflected in the balance sheets referred to in clauses (a) or (b) above.
ARTICLE IV

AFFIRMATIVE COVENANTS

Until all of Borrower's Obligations are paid and performed in full, Borrower agrees that it and each Obligor will:

4.1 **Legal Existence: Good Standing.** Maintain its existence and its good standing in the jurisdiction of its formation and its qualification in each jurisdiction in which the failure so to qualify would have a Material Adverse Effect, and in any event in each jurisdiction in which any portion of the business owned or operated by such Obligor is located.

4.2 **Inspection.** Permit representatives of Lender at Lender's expense, upon five Business Days prior notice if no Event of Default exists, or at any time if any Event of Default exists, to (i) visit its offices, (ii) examine its books and records and Accountants' reports relating thereto, (iii) make copies or extracts therefrom, (iv) discuss its affairs with its employees, (v) examine and inspect its Property, and (vi) meet and discuss its affairs with the Accountants, and such Accountants, as a condition to their retention by such Borrower, are hereby irrevocably authorized by Borrower to fully discuss and disclose all such affairs with Lender (the foregoing items (i) through (vi) hereinafter are referred to collectively as an "Inspection"). Notwithstanding the foregoing, if no Event of Default exists, Lender shall not conduct an Inspection more than once a year.

4.3 **Financial Statements and Other Information.** Maintain a standard system of accounting in accordance with GAAP and furnish to Lender the following items:

4.3.1 **Monthly Statements.** Thirty (30) days after the close of each month that is not a quarter-end or year-end, an internal financial and management report including a consolidated statement of operations and operating cash flow.

4.3.2 **Quarterly Statements.** Forty-five (45) days after the close of any fiscal quarter (i) the consolidated balance sheet of Borrower for fiscal quarter, and (ii) the consolidated statements of operations and operating cash flow of Borrower for such fiscal quarter and for the period from the beginning of the then current year to the end of such fiscal quarter, setting forth in each case in comparative form the corresponding figures for the corresponding period in the preceding year, all in reasonable detail and prepared in accordance with GAAP subject to (i) the absence of any footnotes that may be required by GAAP, and (ii) normal year-end adjustments that are not material in the aggregate.

4.3.3 **Annual Statements.** Ninety (90) days after the close of each fiscal year: the consolidated balance sheet of Borrower as of the end of such year and the consolidated statements of operations, cash flows and stockholders' equity of Borrower for such year (collectively, the "Basic Financial Statements"), and the consolidated statements of operating cash flow of Borrower for such year, setting forth in each case in comparative form the corresponding figures for the preceding year.
4.3.4 Audit Reports. A copy of each report, other than the reports referred to in Subsection 4.3.3, including any so-called "Management Letter" or similar report, submitted to Borrower by the Accountants in connection with any annual, interim or special audit made by the Accountants of the books of Borrower.

4.3.5 Compliance Statement. Concurrent with the delivery of the quarterly and annual Basic Financial Statements, a compliance statement that certifies the calculations of covenant compliance as to those covenants set forth in Sections 4.3.1, 4.3.2 and 4.3.3.

4.4 Notice of Defaults: Loss. Provide Lender with prompt notice if: (i) any Indebtedness of any Obligor is declared or shall become due and payable prior to its declared or stated maturity, or called and not paid when due, (ii) any event has occurred that enables the holder of any note, or other evidence of such Indebtedness, certificate or security evidencing any such Indebtedness of any Obligor to declare such Indebtedness due and payable prior to its stated maturity, (iii) there shall occur and be continuing an Incipient Default or Event of Default, accompanied by a statement setting forth what action Borrower proposes to take in respect thereof, or (iv) any event shall occur which has a Material Adverse Effect, including the amount or the estimated amount of any loss or adverse effect.

4.5 Notice of Suits, Adverse Events. Provide Lender with (i) prompt notice of any citation, summons, subpoena, order to show cause or other order naming any Obligor a party to any proceeding before any Governmental Body which might reasonably be expected to have a Material Adverse Effect and include with such notice a copy of such citation, summons, subpoena, order to show cause or other order, (ii) any lapse or other termination of any license, permit, franchise, agreement or other authorization issued to any Obligor by any Governmental Body or any other Person that is material to the operation of Borrower's Business, (iii) any refusal by any Governmental Body or any other Person to renew or extend any such license, permit, franchise, agreement or other authorization, and (iv) any dispute between any Obligor and any Governmental Body or any other Person, which lapse, termination, refusal or dispute could reasonably be expected to have a Material Adverse Effect.

4.6 Reports to Stockholders and Governmental Bodies. Upon request of the Lender, promptly provide Lender:

(a) copies of any financial statements, reports, notices and other statements sent or made available generally by Borrower to Borrower's stockholders to the extent the same contain any information not included in any financial statements previously furnished to Lender pursuant to Section 4.3, and copies of all regular and periodic reports and all registration statements and prospectuses filed by Borrower with any securities exchange or with the Securities and Exchange Commission or any Governmental Body succeeding to any of its functions, and of all statements generally made available by Borrower or others concerning material developments in the business of any Obligor; and
(b) copies of any periodic or special reports filed by any Obligor with any Governmental Body or Person and copies of any material notices and other communications from any Governmental Body or Person which specifically relate to any Obligor.

4.7 ERISA Notices and Requests.

(a) With reasonable promptness, and in any event within 25 Business Days after occurrence of any of the following, Borrower will give notice of and/or deliver to Lender copies of: (i) the establishment of any new Pension Plan or Multiemployer Plan by any Obligor; (ii) the commencement of contributions to any Pension Plan or Multiemployer Plan to which any Obligor or any of its ERISA Affiliates was not previously contributing or any increase in the benefits of any existing Pension Plan or Multiemployer Plan; (iii) each funding waiver request filed with respect to any Pension Plan and all communications received or sent by any Obligor or any ERISA Affiliate with respect to such request; and (iv) the failure of any Obligor or ERISA Affiliate to make a required installment or payment to a Pension Plan under Section 302 of ERISA or Section 412 of the Code by the due date.

(b) Promptly and in any event within 10 Business Days of becoming aware of the occurrence of or forthcoming occurrence of any (i) Termination Event, or (ii) nonexempt "prohibited transaction", as such term is defined in Section 406 of ERISA or Section 4975 of the Code, in connection with any Pension Plan or any trust created thereunder, Borrower will deliver to Lender a notice specifying the nature thereof, what action the applicable Obligor has taken, is taking or proposes to take with respect thereto and, when known, any action taken or threatened by the Internal Revenue Service, the Department of Labor or the PBGC with respect thereto.

(c) With reasonable promptness but in any event within 10 Business Days after the occurrence of, or receipt of, any of the following, Borrower will deliver to Lender copies of: (i) any favorable or unfavorable determination letter from the Internal Revenue Service regarding the qualification of an Employee Benefit Plan under Section 401(a) of the Code; (ii) all notices received by any Obligor or any ERISA Affiliate of the PBGC's intent to terminate any Pension Plan or to have a trustee appointed to administer any Pension Plan; (iii) each Schedule B (Actuarial Information) to the annual report (Form 5500 Series) filed by any Obligor or any ERISA Affiliate with the Internal Revenue Service with respect to each Pension Plan; and (iv) all notices received by any Obligor or any ERISA Affiliate from a Multiemployer Plan sponsor concerning the imposition or amount of withdrawal liability pursuant to Section 4202 of ERISA. Borrower will notify Lender in writing within two Business Days of any Obligor or any ERISA Affiliate that has filed a notice of intent to terminate any Pension Plan under a distress termination within the meaning of Section 4041(c) of ERISA.

4.8 Other Information.

(a) Provide Lender with prompt notice of any change in the location of any Property of any Obligor which is material to or necessary for the con-
continued operation of Borrower's Business, any change in the name of any Obligor, any sale or purchase of Property outside the regular course of business of any Obligor, and any change in the business or financial affairs of any Obligor, which change would have a Material Adverse Effect.

(b) Promptly upon request therefor, such other information and reports relating to the past, present or future financial condition, operations, plans and projections of Borrower as Lender reasonably may request from time to time. Notwithstanding the foregoing, such requests shall not be made more than two times during a calendar year.

4.9 Reports to Governmental Bodies and Other Persons. Timely file all material reports, applications, documents, instruments and information required to be filed pursuant to all rules, regulations or requests of any Governmental Body or other Person having jurisdiction over the operation of Borrower's Business, including, but not limited to, such of the Loan Instruments as are required to be filed with any such Governmental Body or other Person pursuant to applicable rules and regulations promulgated by such Governmental Body or other Person.

4.10 Maintenance of Licenses, Franchises and Other Agreements. Maintain in full force and effect at all times, and apply in a timely manner for renewal of licenses, franchises, trademarks, tradenames and agreements necessary for the operation of Borrower's Business, the loss of any of which would have a Material Adverse Effect.

4.11 Insurance.

4.11.1 Key Man Life Insurance. Maintain in full force and effect at all times policies of insurance in such form and issued by such insurers as shall be reasonably acceptable to Lender, insuring the life of (i) ______ in the amount of $5,000,000, and (ii) ______ in the amount of $4,000,000, and deliver to Lender, from time to time as Lender reasonably may request, evidence of compliance with this Subsection 4.11.1.

4.11.2 Business Insurance. Maintain in full force and effect at all times Business Insurance as required by the insurance letter agreement between Borrower and Bank.

4.12 Future Leases. Deliver to Lender an executed copy of any lease pertaining to real property entered into by any Obligor and such other documents as pertaining to any lease Lender may reasonably request.

4.13 Future Acquisitions of Real Property. Deliver to Lender executed copies of any contract relating to the purchase by any Obligor of real property, an executed copy of such contract and such other documents as Lender may reasonably request that are related to such purchase.

4.14 Environmental Matters.

4.14.1 Compliance. At all times comply with, and be responsible for, its obligations under all Environmental Laws applicable to the Leasehold Property,
any parcel of real estate acquired in connection with an acquisition and any other Property owned by any Obligor or used by each Obligor in the operation of its business. At its sole cost and expense, each Obligor shall (i) comply in all respects with (A) any notice of any violation or administrative or judicial complaint or order having been filed against such Obligor, any portion of the Leasehold Property, any parcel of real estate acquired in connection with an acquisition or any Property owned by such Obligor or used by such Obligor in the operation of its business alleging violations of any law, ordinance and/or regulation requiring such Obligor to take any action in connection with the release, transportation and/or cleanup of any Hazardous Materials, and (B) any notice from any Governmental Body or any other Person alleging that such Obligor is or may be liable for costs associated with a response or cleanup of any Hazardous Materials or any damages resulting from such release or transportation, or (ii) diligently contest in good faith by appropriate proceedings any demands set forth in such notices.

4.15 Compliance with Laws. Comply with all laws, statutes and regulations relating to federal, state and local laws, ordinances, requirements and regulations and all judgments, orders, injunctions and decrees known and applicable to such Obligor and its operations, that the failure to comply with would have a Material Adverse Effect.

4.16 Taxes and Claims. Pay and discharge all taxes, assessments and governmental charges or levies imposed upon it or upon its income or profits, or upon any Property belonging to it, prior to the date on which penalties attach thereto, and all lawful claims which, if unpaid, might become a Lien (other than a Permitted Lien) upon the property of such Obligor, provided that so long as no Lien has attached to the Property of any Obligor as a result of any of the foregoing, no Obligor shall be required by this Section 4.16 to pay any such amount if the same is being contested diligently and in good faith by appropriate proceedings and as to which the applicable Obligor has set aside reserves on its books reasonably satisfactory to Lender.

4.17 Maintenance of Properties. Maintain all of its Property necessary in the operation of Borrower's Business in good working order and condition.

4.18 Officer Compensation. Officers of the Borrower may be paid reasonable salaries and bonuses in amounts that are customary for businesses similar in size, scope and profitability to that of the Borrower. _________ annual salary and compensation for fiscal 2003 will not exceed $400,000 without the prior written consent of ________.

4.19 Insider Holdings. The Management Team will retain at least seventy-five percent (75%) of their Common Stock owned at the date hereof through the fourth anniversary after Closing and at least fifty-five percent (55%) of their Common Stock owned at the date hereof until the Loan is paid in full, provided that any such sales of stock will be into the public trading market then existing for Borrower's Common Stock. A transfer of up to twenty percent (20%) of holdings of Common Stock by the Management Team for estate planning purposes is permitted and shall be excluded from the above calculations.
4.20 Debt Service Coverage Ratio. The Debt Service Coverage Ratio is defined as the ratio of (i) EBITDAC for the four previous quarters to (ii) cash interest expense and regularly scheduled principal payments for the four most recent complete calendar quarters. Borrower will not permit the Debt Service Coverage Ratio as of the last day of each quarter ending on or about the date set forth below to be less than the ratio set forth opposite such date:

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<tr>
<th>Quarter Ending</th>
<th>Ratio</th>
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<td>December 31, 2002</td>
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<td>March 31, 2007</td>
<td>___ to 1.00</td>
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4.21 Consolidated Indebtedness for Borrowed Money to EBITDA Ratio. The Consolidated Indebtedness for Borrowed Money to EBITDA ratio is defined as the ratio of Consolidated Indebtedness for Borrowed Money to Consolidated EBITDA. Borrower will not permit the Consolidated Indebtedness for Borrowed Money to EBITDA ratio as of the last day of each fiscal quarter ending on or about the date set forth below to be greater than the ratio set forth opposite such date below.
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<tr>
<th>Date</th>
<th>Ratio</th>
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<tr>
<td>June 30, 2006</td>
<td>___ to 1.00</td>
</tr>
<tr>
<td>September 30, 2006</td>
<td>___ to 1.00</td>
</tr>
<tr>
<td>December 31, 2006</td>
<td>___ to 1.00</td>
</tr>
<tr>
<td>March 31, 2007</td>
<td>___ to 1.00</td>
</tr>
</tbody>
</table>

4.22 Minimum Tangible Net Worth. Minimum Tangible Net Worth shall be defined as the Consolidated Tangible Assets of the Obligors, less liabilities of the Obligors, plus the net proceeds of the sale of Capital Stock of the Obligors. Borrower will not permit the Consolidated Tangible Net Worth of the Obligors as of the last day of each quarter ending on or about the date set forth below to be less than the amount specified in the table below.

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount in Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 2002</td>
<td></td>
</tr>
<tr>
<td>March 31, 2003</td>
<td></td>
</tr>
</tbody>
</table>
### Appendix L: Subordinated Loan Agreement

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount in Millions</th>
</tr>
</thead>
<tbody>
<tr>
<td>June 30, 2003</td>
<td></td>
</tr>
<tr>
<td>September 30, 2003</td>
<td></td>
</tr>
<tr>
<td>December 31, 2003</td>
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<td>June 30, 2004</td>
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<td>September 30, 2004</td>
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<tr>
<td>December 31, 2006</td>
<td></td>
</tr>
<tr>
<td>March 31, 2007</td>
<td></td>
</tr>
</tbody>
</table>

## ARTICLE V

### NEGATIVE COVENANTS

So long as at least 50% of Total Debt remains outstanding, no Obligor shall:

5.1 **Borrowing.** Create, incur, assume or suffer to exist any liability for Indebtedness for Borrowed Money except (i) Borrower's Obligations, (ii) Permitted Senior Indebtedness, and (iii) Non-Recourse Indebtedness.

5.2 **Liens.** Create, incur, assume or suffer to exist any Lien upon any of its Property, whether now owned or hereafter acquired, except Permitted Liens.

5.3 **Merger.** Consolidate with or merge into any other corporation, or transfer all or substantially all of its assets to any entity unless permitted by law and unless (i) the resulting, surviving or transferee entity, which shall be a corporation organized and existing under the laws of the United States or a State there-
of, assumes in a form reasonably satisfactory to the Lender, all of the obligations of Borrower under the Loan Instruments, (ii) immediately after giving effect to, and as a result of, such transaction, no Incipient Default or Event of Default shall have occurred and be continuing, and (iii) Lender has waived the application of Section 2.5.2 of this Loan Agreement, which waiver is at Lender’s sole option. Thereafter such successor corporation or corporation shall succeed to and be substituted for Borrower with the same effect as if it had been named herein as the “Company” and all such obligations of the predecessor corporation shall terminate. Borrower shall deliver to the Lender prior to the consummation of the proposed transaction an officers’ certificate to the foregoing effect and an opinion of counsel stating that the proposed transaction complies with this provision. Notwithstanding the foregoing language in this Section 5.3, the Borrower and its Subsidiaries may merge or consolidate with any other Person in accordance with the provisions of Sections 5.16 and 5.17 hereafter; provided, further, however, that any such merger or consolidation does not constitute a Change in Control of the Borrower.

5.4 Contingent Liabilities. Assume, guarantee, endorse, contingently agree to purchase, become liable in respect of any Guarantee, or otherwise become liable upon the obligation of any Person, except (i) liabilities arising from the endorsement of negotiable instruments for deposit or collection, or (ii) the posting of bonds or letters of credit to secure performance to the extent necessary in connection with Borrower’s Business and similar transactions in the ordinary course of business.

5.5 Distributions. Pay any dividends or make any distributions with respect to, or purchase or redeem all or any portion of, the Capital Stock of any Obligor other than distributions (i) to Borrower or its successors in interest by any Obligor other than Borrower with respect to Capital Stock of Borrower (directly or indirectly through another Subsidiary), or (ii) distributions to management of Borrower upon ceasing to be employed.

5.6 Payments of Indebtedness for Borrowed Money. Make any voluntary or optional prepayment of any Indebtedness for Borrowed Money other than Permitted Senior Indebtedness, Borrower’s Obligations and payments made in the ordinary course of business, and Non-Recourse Indebtedness.

5.7 Investments or Loans. At any time purchase or otherwise acquire, hold or invest in the capital stock of, or any other interest in, any Person, or make any loan or advance to, or enter into any arrangement for the purpose of providing funds or credit to, or make any other investment, whether by way of capital contribution or otherwise, in or with any Person, except (i) investments in direct obligations of, or instruments unconditionally guaranteed by, the United States of America or in certificates of deposit issued by a Qualified Depository, (ii) investments in commercial or finance paper which, at the time of investment, is rated either “A” or “P” by Moody’s Investors Service, Inc., or Standard & Poor’s Corporation, respectively, or at the equivalent rate by any of their respective successors, (iii) any interests in any money market account maintained, at the time of investment, with a Qualified Depository, the investments of which, at the time of investment, are restricted to the types specified in clause (i) above, and (iv) the
formation and capitalization of Permitted Subsidiaries. All investments permitted pursuant to clauses (i), (ii) and (iii) of this Section 5.7 shall have a maturity not exceeding one year.

5.8 **Fundamental Business Changes.** Materially change the nature of its business.

5.9 **Facility Sites.** Change the locations of its offices or other Property used in the operation of Borrower’s Business unless such Obligor shall have complied with all applicable laws, rules and regulations and shall have received all required consents and approvals from any Governmental Body.

5.10 **Sale or Transfer of Assets.** Except in the ordinary course of business, sell, lease, assign, transfer, sublease or otherwise dispose of 10% or more of the Borrower’s Consolidated Assets (excluding inventory and leased assets) on a rolling 12 month basis or 20% in the aggregate (collectively, the “Benchmark”) without the prior consent of ________, except for the sale or disposition of (i) Property which is not material to or necessary for the continued operation of Borrower’s Business, (ii) obsolete or unusable items of equipment which promptly are replaced with new items of equipment of like function and comparable value to the unusable items of equipment when the same were new or not obsolete, and (iii) doubtful accounts receivable for collection purposes in the ordinary course of business. In the event of any proposed sale or transfer of the Borrower’s Consolidated Assets that exceed the Benchmark, the proceeds of such sale or transfer of Borrower’s Consolidated Assets shall (i) be representative of the fair market value of such Consolidated Assets as are sold or transferred, and (ii) be subject to application by Borrower in accordance with the mutually acceptable and commercially reasonable agreement of Borrower and Agent, subject to the provisions of the Subordination Agreement.

5.11 **Amendment of Certain Documents.** Amend, modify or waive any term or provision of the articles of incorporation or bylaws of Borrower or the Permitted Subsidiaries that would materially and adversely affect the Lender.

5.12 **Acquisition of Additional Properties.** Acquire any additional Property except such Property as is necessary to or useful in the operation of such Borrower’s Business, provided such acquisitions shall be subject to the conditions and limitations set forth in this Loan Agreement.

5.13 **Compliance with ERISA.**

(a) Permit the occurrence of any Termination Event which would result in a liability to any Obligor or ERISA Affiliate in excess of $50,000.

(b) Permit the present value of all benefit liabilities under all Pension Plans to exceed the current value of the assets of such Pension Plans allocable to such benefit liabilities by more than $50,000.

(c) Permit any accumulated funding deficiency in excess of $50,000 (as defined in Section 302 of ERISA and Section 412 of the Code) with respect to any Pension Plan, whether or not waived.
(d) Fail to make any contribution or payment to any Multiemployer Plan which any Obligor or ERISA Affiliate may be required to make under any agreement relating to such Multiemployer Plan, or any law pertaining thereto which results in or is likely to result in a liability in excess of $50,000.

(e) Engage, or permit any Obligor or ERISA Affiliate to engage, in any “prohibited transaction” as such term is defined in Section 406 of ERISA or Section 4975 of the Code for which a civil penalty pursuant to Section 502(i) of ERISA or a tax pursuant to Section 4975 of the Code in excess of $50,000 is imposed.

(f) Permit the establishment of any Employee Benefit Plan providing postretirement welfare benefits or establish or amend any Employee Benefit Plan which establishment or amendment could result in liability to any Obligor or ERISA Affiliate or increase the obligation of any Obligor or ERISA Affiliate to a Multiemployer Plan which liability or increase, individually or together with all similar liabilities and increases, is material to any Obligor or ERISA Affiliate.

(g) Fail, or permit any Obligor or ERISA Affiliate to fail to establish, maintain and operate each Employee Benefit Plan in compliance in all material respects with ERISA, the Code and all other applicable laws and regulations and interpretations thereof.

5.14 Transactions with Affiliates. Enter into or modify any transactions or contracts executed prior to the date of this Loan Agreement with Affiliates of the Obligors on terms that are materially less favorable to the Obligors than transactions or contracts with unrelated parties obtained in arm’s length dealings.

5.15 Derivative Contracts. Neither Borrower nor any of its Subsidiaries shall enter into any interest rate protection agreement, foreign currency exchange contract or other financial or commodity derivative contracts except as permitted by the Bank Loan Agreement or to provide hedge protection for an underlying economic transaction in the ordinary course of business.

5.16 Acquisitions. None of the Obligors shall enter into an agreement for an Acquisition of any other Person, or become contractually committed to do so, except:

(a) any Acquisition of any Person, the purchase price for which does not exceed $5,000,000 (whether comprised of cash, securities, Indebtedness, Senior Indebtedness or any combination thereof); or

(b) any Acquisition with a purchase price in excess of $5,000,000, subject to the condition that Consolidated Senior Indebtedness for Borrowed Money to EBITDA, as adjusted to reflect the historical EBITDA of the Person to be so acquired for the immediately preceding 12 month period does not exceed __ to 1.00; provided, further, that the Consolidated Senior Indebtedness for Borrowed Money applied for working capital or Acquisitions by Borrower shall not exceed $____.
5.17 **Sale of Subsidiaries.** The Borrower shall not sell, merge or liquidate any Subsidiary of the Borrower except:

(a) any merger or liquidation of a Subsidiary into the Borrower or any other Subsidiary of the Borrower, so long as the Borrower shall be the surviving or resulting Person if a party thereto;

(b) permitted Acquisitions as described pursuant to Section 5.16;

(c) so long as immediately before and after giving effect to such sale, merger or liquidation no Default exists and the Borrower and the Agent reasonably agree upon the application of any proceeds therefrom, subject in each case to the Subordination Agreement; and

(d) licensing of products and intangible assets of the Subsidiaries in the ordinary course of business.

5.18 **Capital Expenditures.** The Borrower will not, and will not permit its Subsidiaries to, make Consolidated Capital Expenditures during any year that exceed ___% of the Consolidated Assets of the Obligors (which Consolidated Assets may be increased as a result of any Acquisition of any other Person by any of the Obligors); provided, however, that if at the end of any year (the “Prior Year”) the amount that the Obligors were entitled to devote to Consolidated Capital Expenditures was less than the amount of the actual Consolidated Capital Expenditures made during such Prior Year (the “Excess Amount”), the Obligors may make additional Consolidated Capital Expenditures in the immediately succeeding year in an amount equal to the Excess Amount from the Prior Year in addition to such succeeding year’s permitted Consolidated Capital Expenditures.

**ARTICLE VI**

**SUBORDINATION**

6.1 **Subordination.**

6.1.1 **Subject to Subordination Agreement.** The payment of any and all of Borrower’s Obligations and the exercise of any right or remedy pursuant to any Loan Instrument are expressly subject to the provisions of the Subordination Agreement.

6.1.2 **Subordination Not to Be Impaired.** No right of any holder of Senior Indebtedness to enforce the subordination of the Loan evidenced by the Loan Agreement shall be impaired by any act or failure to act by the Obligors or by their failure to comply with this Loan Agreement.

6.2 **Subordination Upon Bankruptcy or Insolvency.** In the event of (a) any insolvency or bankruptcy case or proceeding under the Bankruptcy Code or any other similar federal or state law or any receivership, liquidation, reorganization or other similar case or proceeding in connection therewith, against or with respect to the Borrower or any Subsidiary (for purposes of this Article VI, any or
all of them, a “Debtor Party”) or any of their property, (b) any liquidation, dissolution or other winding-up of any Debtor Party, whether voluntary or involuntary and whether or not involving insolvency or bankruptcy, or (c) any assignment for the benefit of creditors or any other marshalling of assets and liabilities of any Debtor Party, then and in any such event:

6.2.1 Senior Debt Entitlement. The Senior Debt Holders shall be entitled to receive payment in full in cash of all amounts due or to become due on or in respect of all Senior Indebtedness, before the Lenders are entitled to receive any payment on account of the Loan;

6.2.2 Payments or Distributions. Any payment or distribution of any kind or character, whether in cash, property or securities, by set-off or otherwise, to which the Lenders would be entitled but for the provisions of this Article VI, including any such payment or distribution which may be payable or deliverable by reason of the payment of any other indebtedness of any Debtor Party being subordinated to the payment of the Loan, shall be paid by the liquidating trustee or agent or other person making such payment or distribution whether a trustee in bankruptcy, a receiver or liquidating trustee or otherwise, directly to the Senior Debt Holders, to the extent necessary to make payment in full in cash of all Senior Indebtedness remaining unpaid, after giving effect to any concurrent payment or distribution to the Senior Debt Holders; and

6.2.3 Lender Receipt of Payment or Distribution. In the event that, notwithstanding the foregoing provisions of this Section 6.2, any Lender shall have received such payment or distribution of any kind or character, whether in cash, property or securities, before all Senior Indebtedness is paid in full in cash, then and in such event such payment or distribution shall be deemed to be the property of, segregated, received and held in trust for the benefit of and shall be immediately paid over or delivered forthwith to the Senior Debt Holders (in the same form as received, with any necessary endorsement) to the extent necessary to make payment in full (or, in the case of non-cash property or securities, to be held as collateral for such payment in full in cash) of all Senior Indebtedness remaining unpaid until all such Senior Indebtedness shall have been paid in full in cash, after giving effect to any concurrent payment or distribution to the Senior Debt Holders. In the event that any Lender fails to provide any necessary endorsement as contemplated above, the Senior Debt Holders are hereby irrevocably authorized to appropriately make the same.

The Borrower shall give prompt notice to the Lenders of the occurrence of any of the events referred to in Section 6.2.

Each Lender irrevocably authorizes and empowers the Senior Debt Holders in any proceedings under any federal or state bankruptcy or insolvency law, or any other reorganization, dissolution or liquidation proceedings of any Debtor Party to file a proof of claim on behalf of such Lender with respect to the Loan and the other amounts owing hereunder and the Notes if such Lender fails to file proof of its claims prior to fourteen (14) days before the expiration of the time period during which such proof must be filed. Neither this Section 6.2, nor any other provisions hereof, shall be construed to give the Senior Debt Holders any
right to vote any of Borrower's Obligations to Lender, or any related claim, or any portion of such claim, whether in connection with any resolution, arrangement, plan of reorganization, compromise, settlement, election of trustees or otherwise.

6.3 Subordination Upon Default or Acceleration of Senior Indebtedness.

6.3.1 Payment and Non-Payment Defaults.

(a) In the event of any Event of Default (as defined in the Bank Loan Agreement) in the payment of principal of or premium or interest on, or any other amount owing with respect to, any Senior Indebtedness, whether at maturity, by acceleration or otherwise ("Payment Default"), or (b) in the event that any Event of Default (as defined in the Bank Loan Agreement) (other than an event described in clause (a)) (a "Non-Payment Default") with respect to any Senior Indebtedness shall have occurred and be continuing, permitting the holder of such Senior Indebtedness to declare such Senior Indebtedness due and payable prior to the date on which it would otherwise have become due and payable, then (i) no payment or distribution of any kind or character whether in cash, property or securities shall be made by any Debtor Party or any other Person on account of the Loan, and no such payment or distribution shall be accepted by any Lender, directly or indirectly, by set-off or otherwise (x) in the case of any Payment Default from the date of such Payment Default until the earlier of (1) the date upon which the Senior Indebtedness shall be paid in full in cash or (2) the date, if any, on which such Payment Default is cured or waived in writing by the Required Senior Debt Holders (defined as "Required Banks" referred to and as defined in the Bank Loan Agreement) or (y) in the case of any Non-Payment Default, from the date Borrower first received a written notice from the Senior Agent of such Non-Payment Default and that the Senior Debt Holders expressly intend that a Payment Blockage Period (as defined hereinafter) is to commence until the earlier of (1) 180 days after such date, (2) the date on which the Senior Indebtedness shall be paid in full in cash, or (3) the date, if any, on which such Non-Payment default is cured or waived by the Required Senior Debt Holders or that the provisions of this paragraph have been waived by the Required Senior Debt Holders (any such period described in clause (x) or (y) shall be referred to as a "Payment Blockage Period"); provided, however, that,

(i) during any 12-month period, no more than one (1) written notice commencing a Payment Blockage Period relating to any Non-Payment Default with respect to any Senior Indebtedness may be given by the Senior Agent; and

(ii) no more than an aggregate of three (3) written notices with respect to Payment Blockage Periods may be given pursuant to this Section 6.3 with respect to a Non-Payment Default during the period from the date hereof to and including the date the Loan has been paid in full.

(b) Any notice commencing a Payment Blockage Period given by the Senior Agent to Borrower pursuant to this Section 6.3 shall specify in reasonable detail the default which is continuing and the basis upon which such notice is being given and shall state that no amounts shall be payable by any
Debtor Party or any other Person in respect of the Borrower's Obligations to Lender in accordance with this Section 6.3. Borrower, forthwith upon receipt of any such notice, shall send copies thereof to the Lenders.

(c) In the event that, notwithstanding the foregoing, any Debtor Party or any other Person shall make any payment or distribution of any kind or character, whether in cash, property or securities to any Lender prohibited by the foregoing provisions of this Section 6.3, or any Lender shall accept the same, then and in such event such payment or distribution shall be deemed to be the property of, segregated, received and held in trust for the benefit of and shall be immediately paid over and delivered forthwith to the Senior Debt Holders (in the same form as received, with any necessary endorsement) to the extent necessary to make payment in full (or, in the case of non-cash property or securities, to be held as collateral for such payment in full in cash) of all Senior Indebtedness remaining unpaid until all such Senior Indebtedness shall have been paid in full, after giving effect to any concurrent payment or distribution to the Senior Debt Holders. In the event that any Lender fails to provide any necessary endorsement as contemplated above, the Senior Debt Holders are hereby irrevocably authorized to appropriately make the same.

6.3.2 Limitation on Action. During any Payment Blockage Period, no holder of Borrower's Obligations to Lender shall take any Action provided, however, that:

(a) the foregoing limitation on taking any Action shall not be applicable following the occurrence of an event as to which Section 6.2 shall apply;

(b) the foregoing limitation on taking any Action shall terminate on the earlier of (1) 180 days after the date of commencement of such Payment Blockage Period, (2) the date on which the Senior Indebtedness shall be paid in full in cash, or (3) the date, if any, on which the Default giving rise to the Payment Blockage Period is cured or waived by the Required Senior Debt Holders, or that the provisions of this paragraph have been waived by the Required Senior Debt Holders;

(c) no further limitation on taking Actions set forth in this Section 6.3.2 shall become effective within twelve (12) months after the commencement of any Payment Blockage Period, whether as a result of a Payment Default or a Non-Payment Default; and

(d) the limitation on taking Actions set forth in this Section 6.3.2 shall not become effective on more than an aggregate of three (3) occasions during the period from the date hereof to and including the date the Loan has been paid in full.

6.4 Lenders' Rights and Remedies.

6.4.1 Obligation of Debtor Party. Subject to the rights, if any, of the Senior Debt Holders (a) in any case or proceeding of any Debtor Party referred to in Section 6.2, to receive, pursuant to and in accordance with such section, cash, property or securities otherwise payable or deliverable to any Lender, (b) under
the conditions specified Section 6.3.1, to prevent the making or acceptance of any payment or distribution, and (c) under the conditions specified in Section 6.3.2, to prevent the taking of any Action, nothing contained in this Article VI or elsewhere in this Agreement or in the Note shall affect the obligation of any Debtor Party to make, or prevent any Debtor Party from making, payments at any time of principal of or interest or premium, if any, on the Loan or any fees or other amounts payable by any Debtor Party under this Agreement or the Notes or, prevent the Lenders from exercising all remedies otherwise permitted by this Agreement, the Note or applicable law upon default under this Agreement or the Note.

6.4.2 **Lenders’ Obligations.** With respect to the Senior Indebtedness, the Lenders undertake to perform only such obligations on the part of the Lenders as are specifically set forth in this Article VI, and no implied covenants or obligations with respect to the Senior Debt Holders shall be read into this Article VI against the Lenders.

6.5 **Prepayments.**

6.5.1 **To Lenders.** The Lenders agree, with and for the benefit of the Senior Debt Holders but not with or for the benefit of any Debtor Party, that until all Senior Indebtedness has been paid in full in cash, they will not accept any prepayment, whether optional or mandatory (other than in connection with an acceleration of the Borrower’s Obligations to Lender, in which case the provisions of Section 6.2 and Section 6.3 shall apply) of the Loan from any Debtor Party without the consent of the Senior Debt Holders. If, notwithstanding the foregoing, any prepayment is accepted by any Lender, directly or indirectly, by set-off or otherwise, then and in such event such payment shall be deemed to be the property of, segregated, received and held in trust for the benefit of and shall be immediately paid over and delivered forthwith to the Senior Debt Holders (in the same form received, with any necessary endorsement) to the extent necessary to make payment in full (or, in the case of non-cash property or securities, to be held as collateral for such payment in full in cash) of all Senior Indebtedness remaining unpaid until all such Senior Indebtedness shall have been paid in full in cash, after giving effect to any concurrent payment or distribution to the Senior Debt Holders. In the event that any Lender fails to provide any necessary endorsement as contemplated above, the Senior Debt Holders are hereby irrevocably authorized to appropriately make the same. Each Debtor Party acknowledges and agrees that any cash or other property which is turned over to the Senior Debt Holders pursuant to this Section 6.5 shall not be deemed to have been received on account of the Borrower’s Obligations to Lender.

6.5.2 **Notice.** Subject to Section 6.2, Lenders shall not take any Action as a result of any Default or Event of Default unless four (4) Business Days prior written notice of such Default or Event of Default and Lenders’ intention to take Action has been given by or on behalf of the Lenders to the Senior Agent (as defined hereinafter).

6.6 **Subrogation to Rights of Senior Debt Holders.** Subject to the payment in full in cash of all Senior Indebtedness, the Lenders shall be subrogated to the rights of the Senior Debt Holders to receive payments and distributions of
cash, property or securities applicable to the Senior Indebtedness until the principal of and interest and premium, if any, on the Loan and any fees or other amounts payable by any Debtor Party under this Agreement, or the Loan shall be paid in full. For purposes of such subrogation, no payments or distributions to the Senior Debt Holders of any cash, property or securities to which the Lenders would be entitled except for the provisions of this Article VI, and no payments over pursuant to the provisions of this Article VI to the Senior Debt Holders by any of the Lenders, as among the Debtor Parties, their creditors other than the Senior Debt Holders, and the Lenders, be deemed to be a payment or distribution by any Debtor Party to or on account of the Senior Indebtedness. The provisions of this Section 6.6 shall survive the termination of this Agreement.

6.7 No Waiver of Subordination Provisions.

6.7.1 No Prejudice. No right of any present or future Senior Debt Holder to enforce subordination as herein provided shall at any time in any way be prejudiced or impaired by any act or failure to act on the part of Borrower, or by any non-compliance by any Debtor Party with the terms, provisions and covenants of this Agreement or the Note, regardless of any knowledge thereof any such Senior Debt Holder may have or be otherwise charged with.

6.7.2 Certain Actions of Senior Debt Holders. Without in any way limiting the generality of the foregoing paragraph, the Senior Debt Holders may, at any time and from time to time, without the consent of or notice to the Lenders, without incurring responsibility to the Lenders, and without impairing or releasing the subordination in this Article VI or the obligations hereunder of the Lenders to the Senior Debt Holders, do any one or more of the following: (a) enter into any new agreement with respect to Senior Indebtedness, change the manner, place or terms of payment or extend the time of payment of, or renew, amend, modify, or alter any Senior Indebtedness or any instrument evidencing the same or any instrument evidencing, governing, creating, guaranteeing or securing any Senior Indebtedness (including the Bank Loan Agreement or any of the other Bank Loan Documents); provided, that no such act or omission shall (i) increase the amount of Senior Indebtedness (except as provided in the definition of Senior Indebtedness) or modify the amortization schedule thereof, (ii) change the interest rate payable thereon (except that the Applicable Margin (as defined in the Bank Loan Agreement) may be increased by a maximum of one percent (1%), (iii) extend the final maturity thereof, or (iv) add or change any event of default or covenant if such addition or change would make such event of default or covenant more restrictive, (b) sell, exchange, not perfect, release or otherwise deal with any guarantees, property pledged, mortgaged, assigned or otherwise securing the Senior Indebtedness and make any settlements and compromises thereof, (c) release any Person liable in any manner for the Senior Indebtedness, (d) exercise or refrain from exercising any rights against the Debtor Parties and any other Person, (e) apply any sums from time to time received to the Senior Indebtedness in such manner as the Senior Debt Holders determine, and (f) subject to the foregoing, otherwise manage and supervise the Senior Indebtedness in accordance with the usual practices, modified from time to time as deemed appropriate under the circumstances, of the Senior Debt Holders.
6.8 **The Senior Agent.** Whenever a payment or distribution is to be made or delivered, or a notice given, to or by the Senior Debt Holders, such payment or distribution shall be made, and such notice shall be given, and the Lenders shall be fully protected in so making such payment or giving such notice and shall not be liable to any other Senior Debt Holders in doing so, to or by Bank, as representative for the Senior Debt Holders, or such other person as shall be set forth in a writing delivered from the Senior Debt Holders (or such person, the ("Senior Agent")). to the Senior Agent at its address set forth in the Bank Loan Agreement.

6.9 **Reliance on Judicial Order or Certificate of Liquidating Agent.** Upon any payment or distribution referred in this Article VI, each of the Lenders shall be entitled to rely upon any order or decree by any court of competent jurisdiction in which such insolvency, bankruptcy, receivership, liquidation, reorganization, dissolution, winding-up or similar case or proceeding is pending, or a certificate of the trustee in bankruptcy, receiver, liquidating trustee, custodian, assignee for the benefit of creditors, agent or other Person making such payment or distribution, delivered to the Lenders for the purpose of ascertaining the Persons entitled to participate in such payment or distribution, the Holders of Senior Indebtedness and other Indebtedness of any Debtor Party, the amount thereof or payable thereon, the amount or amounts paid or distributed thereon and all other facts pertinent thereto or to this Article VI.

6.10 **Lenders Entitled to Assume Payments Not Prohibited in Absence of Notice.** The Lenders shall not at any time be charged with knowledge of the existence of any facts which would prohibit the making of any payment to them, unless and until _______, so long as it is a holder of a Note, and thereafter the Lenders, shall have received a written notice at its address specified in Section 11.1 of this Loan Agreement (or such other address which shall have been given in writing to the Senior Agent and Borrower) from Borrower or from the Senior Agent; and prior to the receipt of any such written notice, the Lenders shall be entitled to assume conclusively that no such facts exist, without, however, limiting any rights of the Senior Debt Holders under this Article VI to recover from the Lenders, or the obligation of the Lenders to turn over to the Senior Debt Holders any payment made to any Lender which such Lender is not entitled under this Article VI to retain.

6.11 **Information as to Subordination.** No Debtor Party or its agent shall publish or give to any creditor or prospective creditor of any Debtor Party any copy, statement or summary (or acquiesce in the publication or giving of any such copy, statement or summary) as to the subordination of the rights of the Lenders without also stating, or causing to be stated (in a conspicuous manner in the case of any document), that such subordination is solely for the benefit of the Senior Debt Holders and not for the benefit of any other creditor of any Debtor Party.

6.12 **Effect of Failure to Pay Loan.** The failure to make a payment on account of principal of or interest or premium, if any, on the Loan by reason of any provision of this Article VI will not be construed as preventing the occurrence of a Default or Event of Default under this Agreement or, except as expressly provided
in Section 6.3 hereof, impair the right of any Lender to declare the Note immedi-
ately due and payable upon the occurrence thereof.

6.13 **Specific Performance.** The parties herein acknowledge that legal
remedies may be inadequate and therefore the Senior Debt Holders are hereby
authorized to demand specific performance of the provisions of this Article VI,
whether or not the Debtor Parties shall have complied with any of the provisions
of this Article VI applicable thereto, at any time when the Debtor Parties or any
Lender shall have failed to comply with any provision hereof. Each Lender here-
by irrevocably waives any defense based on the adequacy of a remedy at law that
might be asserted as a bar to such remedy of specific performance.

6.14 **Security Interests and Liens.** Each Lender agrees with and for the
benefit of the Senior Debt Holders, but not with or for the benefit of the Debtor
Parties, that until the Senior Indebtedness is paid in full in cash, they will not
take any action to obtain, or accept without the consent of the Senior Debt
Holders, any security interest or lien upon any assets of the Debtor Parties. If,
notwithstanding the foregoing, any Lender acquires any such security interest or
lien, whether by operation of law or otherwise, all such security interests and liens
shall be, and hereby are, subordinated to the security interests and liens of the
Senior Debt Holders upon such assets, regardless of the date, manner, order or
perfection of any such security interests or liens. Moreover, to the extent that any
Lender acquires any such security interest or lien, whether by operation of law or
otherwise, (a) each Lender agrees that until the Senior Indebtedness is paid in full
in cash, no Lender will take possession of any assets subject to any such security
interest or lien, (b) no Lender will foreclose upon any such assets, whether by judi-
cial action or otherwise, and (c) each Lender will, upon the request of the Senior
Debt Holders, execute and deliver such documents, and take such further action,
as shall be necessary to release any such security interest or lien. Each Lender
hereby waives any rights it might have under applicable law to assert the doctrine
of marshaling or otherwise to require the Senior Debt Holders to marshal any
assets of any Debtor Party for the benefit of any Lender.

6.15 **Legend.** Until the Senior Indebtedness shall have been paid in full in
cash, any and all Notes or other instruments evidencing the Borrower's
Obligations to Lender which are issued pursuant to this Agreement shall contain
the following legend which shall be exhibited prominently thereon:

"THIS NOTE IS SUBORDINATED AND SUBJECT TO THE PRIOR
PAYMENT IN FULL OF BORROWER'S SENIOR INDEBTED-
NESS. THE HOLDER OF THIS NOTE BY THE ACCEPTANCE
HEREOF COVENANTS AND AGREES THAT ALL PAYMENTS OF
PRINCIPAL AND INTEREST AND ALL OTHER AMOUNTS
OWING WITH RESPECT TO THIS NOTE SHALL BE SUBORDI-
NATED IN ACCORDANCE WITH THE PROVISIONS OF ARTICLE
VI OF THIS LOAN AGREEMENT AND THE HOLDER ACCEPTS
AND AGREES TO BE BOUND BY SUCH PROVISIONS."
6.16 **Reliance.** The Lenders acknowledge and agree that the provisions of this Article VI are, and are intended to be, an inducement and a consideration to each Senior Debt Holder, whether the Senior Indebtedness was created or acquired before or after the issuance of the Notes, to acquire and/or continue to hold such Senior Indebtedness and such Senior Debt Holder shall be deemed conclusively to have been a third party beneficiary of, and to have relied on, the provisions of this Article VI in acquiring and/or continuing to hold such Senior Indebtedness.

6.17 **Amendments.** Until the Senior Indebtedness has been paid in full in cash, none of the Debtor Parties or any Lender may enter into written amendments, supplements or modifications to the provisions of this Article VI without the consent of the required Senior Debt Holders. The Lenders may execute and deliver to Borrower a written instrument waiving, on such terms and conditions as the Lenders may specify in such instrument, any of the requirements of this Article VI, provided, that until the Senior Indebtedness has been paid in full in cash, no such waiver shall be executed and delivered without the consent of the Required Senior Debt Holders. Notwithstanding the foregoing, the consent of any Debtor Party shall not be required for any amendment, supplement, modification or waiver of Section 6.5 or Section 6.14 or of the following sentence. The Debtor Parties and each Lender agree with and for the benefit of the Required Senior Debt Holders, they will not, without the written consent of the Required Senior Debt Holders, directly or indirectly, agree to the amendment, supplement or modification of any term or provision of this Agreement or the Note if the effect of any such amendment, supplement or modification, directly or indirectly, is to (a) increase the rates of interest on the Loan hereunder, (b) shorten the final maturity or change the amortization schedule of the Loan, or (c) add or change any Event of Default or add or change any covenant if such addition or change would make such Event of Default or covenant more restrictive or increase the premiums payable hereunder in connection with a prepayment of the Loan or impose any additional fees which are not reasonable under the circumstances.

6.18 **Further Assurances.** Each party hereto will, upon the written request of any other party hereto, from time to time execute and deliver or cause to be executed and delivered such further instruments and agreements and do or cause to be done such further acts as may be reasonably necessary or proper to carry out more effectively the provisions of this Article VI.

**ARTICLE VII**

**DEFAULT AND REMEDIES**

7.1 **Events of Default.** The occurrence of any of the following shall constitute an Event of Default under the Loan Instruments:

7.1.1 **Default in Payment.** If the Borrower shall fail to make any interest or principal payment when due and such failure continues for a period of five consecutive Business Days after Borrower has received written notice from Lender of such failure to pay.
7.1.2 Breach of Covenants.

(a) If any Obligor shall fail to observe or perform any covenant or agreement governing such Obligor contained in Section 4.1, 4.2, 4.10, 4.11 or 4.14 or Article V.

(b) If any Obligor shall fail to observe or perform any covenant or agreement (other than those referred to in subparagraph (a) above or specifically addressed elsewhere in this Section 7.1) made by such Obligor in any of the Loan Instruments to which such Obligor is a party, and such failure shall continue for a period of 30 days after notice of such failure is given by Lenders, provided that, if such failure is in connection with Section 4.10, such Obligor shall have an additional 30 days to cure such failure, if such Obligor (i) is diligently pursuing a cure for such failure, and (ii) provides Lender with evidence to that effect in form and substance reasonably satisfactory to Lender.

7.1.3 Breach of Warranty. If any representation or warranty made by or on behalf of any Obligor in or pursuant to any of the Loan Instruments or in any instrument or document furnished in compliance with the Loan Instruments shall prove to be false or misleading in any material respect on the date as of which made.

7.1.4 Default Under Other Indebtedness for Borrowed Money. If (i) any Obligor at any time shall be in default (as principal or guarantor or other surety) in the payment of any principal of or premium or interest on any Indebtedness for Borrowed Money (other than Borrower's Obligations) beyond the grace period, if any, applicable thereto and the aggregate amount of such payments then in default beyond such grace period shall exceed $250,000, or (ii) any default shall occur in respect of any issue of Indebtedness for Borrowed Money of any Obligor (other than Borrower's Obligations) outstanding in a principal amount of at least $400,000, or in respect of any agreement or instrument relating to any such issue of Indebtedness for Borrowed Money, and such default shall continue beyond the grace period, if any, applicable thereto.

7.1.5 Bankruptcy.

(a) If any Obligor shall (i) generally not be paying its debts as they become due, (ii) file, or consent, by answer or otherwise, to the filing against it of a petition for relief or reorganization or arrangement or any other petition in bankruptcy or insolvency under the laws of any jurisdiction, (iii) make an assignment for the benefit of creditors, (iv) consent to the appointment of a custodian, receiver, trustee or other officer with similar powers for such Obligor, or for any substantial part of the property of such Obligor, or (v) be adjudicated insolvent.

(b) If any Governmental Body of competent jurisdiction shall enter an order appointing, without consent of such Obligor, a custodian, receiver, trustee or other officer with similar powers with respect to such Obligor, or with respect to any substantial part of the property of such Obligor, or if an order for relief shall be entered in any case or proceeding for
liquidation or reorganization or otherwise to take advantage of any bankruptcy or insolvency law of any jurisdiction, or ordering the dissolution, winding up or liquidation of any Obligor or if any petition for any such relief shall be filed against any Obligor and such petition shall not be dismissed or stayed within 60 days.

7.1.6 Judgments. If there shall exist a final judgment or award against the Borrower which shall have been outstanding and unpaid for a period of 30 days or more from the date of the entry thereof and shall not have been discharged or paid in full or stayed pending appeal, if the aggregate amount of all such unpaid judgments and awards exceeds $100,000 and is not covered by insurance.

7.1.7 Impairment of Licenses; Other Agreements. If (i) any Governmental Body shall revoke, terminate, suspend or adversely modify any material license of any Obligor, the non-continuation of which could reasonably be expected to have a Material Adverse Effect, or (ii) there shall exist any violation or default in the performance of, or a material failure to comply with any agreement, or condition or term of any license, which violation, default or failure has a Material Adverse Effect, or any such licenses that are material to Borrower's Business shall cease to be in full force and effect, or (iii) any agreement which is materially necessary to the operation of Borrower's Business shall be revoked or terminated and not replaced by a substitute reasonably acceptable to Lender within 30 days after the date of such revocation or termination, and such revocation or termination and non-replacement could reasonably be expected to have a Material Adverse Effect.

7.1.8 Plans. If an event or condition specified in Section 4.7 hereof shall occur or exist with respect to any Pension Plan or Multiemployer Plan and, as a result of such event or condition, together with all other such events or conditions, Borrower or any member of a Controlled Group shall incur, or in the opinion of Lender be reasonably likely to incur, a liability to a Pension Plan or Multiemployer Plan or the PBGC (or any of them) which, in the reasonable judgment of Lender, would have a Material Adverse Effect.

7.1.9 Change in Control. If at any time there is a Change in Control of Borrower.

7.1.10 Acceleration of Any Indebtedness. If the acceleration of any Indebtedness (other than Non-Recourse Indebtedness) of Borrower or any Subsidiary is in an amount of $30 million or more, individually or in the aggregate, and such acceleration does not cease to exist, or such Indebtedness is not satisfied, in either case within 30 days after such acceleration.

7.2 Acceleration of Borrower's Obligations. Upon the occurrence of any Event of Default described in Sections 7.1.5(a), 7.1.5(b) and 7.1.9, the Principal Balance and any accrued but unpaid interest, shall mature and become due subject to the provisions of the Subordination Agreement, and the Lender, at any time (unless such Event of Default shall have been waived in writing or remedied), at its option, without further notice or demand, may declare all of the Borrower's Obligations to Lender due and payable immediately, all without presentment,
demand, protest or notice other than the declaration referred to above, all of which hereby are waived subject to the provisions of the Subordination Agreement. Upon the occurrence of any other Event of Default that shall have occurred and be continuing, Lenders holding a Percentage Interest of not less than 67% in the aggregate of the Principal Balance may, by notice to the Borrower, declare to be due and payable immediately the Principal Balance and any accrued and unpaid interest thereon subject to the provisions of the Subordination Agreement and, if such Event of Default is not involuntary, plus a Prepayment Premium calculated in the manner provided under Section 2.5.2 of this Loan Agreement; provided, however, that if sufficient payment or deposits shall have been made to pay the Principal Balance of, Prepayment Premium, if any, and interest on the Borrower's Obligations to Lender due otherwise than by such declaration plus reasonable attorneys' fees, if any, incurred by Lender, and any and all defaults (other than the nonpayment of Principal Balance, Prepayment Premium, if any, and accrued and unpaid interest on the Loan that shall have become due by such declaration) shall have been remedied or waived, Lenders holding a Percentage Interest of not less than 67% in the aggregate of the Principal Balance may waive all defaults and rescind and annul such declaration and consequences.

7.3 Remedies on Default. If Borrower's Obligations have been accelerated pursuant to Section 7.2, Lender, at its option, may, subject in all events to the subordination provisions contained in the Subordination Agreement:

7.3.1 Enforcement of Rights and Remedies. Enforce its rights and remedies under the Loan Instruments in accordance with their respective terms.

7.3.2 Other Remedies. Enforce any of the rights or remedies accorded to Lender at equity or law, by virtue of statute or otherwise.

7.4 Application of Funds. Any funds received by Lender pursuant to the exercise of any rights accorded to Lender pursuant to, or by the operation of any of the terms of, any of the Loan Instruments shall be applied, subject to the subordination provisions contained in the Subordination Agreement, to Borrower's Obligations in the following order of priority:

7.4.1 Expenses. First, to the payment of all reasonable fees and expenses actually incurred, including, without limitation, court costs and all other costs incurred by Lender in exercising any rights accorded to Lender pursuant to the Loan Instruments or by applicable law, including, without limitation, reasonable attorneys' fees.

7.4.2 Borrower's Obligations. Next, to the payment of the remaining portion of Borrower's Obligations in such order as Lenders may determine.

7.4.3 Surplus. Any surplus, to the Person or Persons entitled thereto.

7.5 Performance of Borrower's Obligations. If any Obligor fails to (i) maintain in force and pay for any insurance policy or bond which such Obligor is required to provide pursuant to any of the Loan Instruments, (ii) keep fully and perform promptly any other of the material obligations of such Obligor hereunder or under any of the other Loan Instruments, and (iii) keep fully and perform
promptly the obligations of such Obligor with respect to any issue of Indebtedness for Borrowed Money secured by a Permitted Prior Lien, then Lender may (but shall not be required to) make good any aforesaid failure of such Obligor. Borrower shall reimburse Lender immediately upon demand for all reasonable sums paid or advanced on behalf of any Obligor for any such purpose, together with reasonable and/or necessary costs and expenses (including reasonable attorneys’ fees) paid or incurred by Lender in connection therewith and interest on all sums advanced from the date of advancement until repaid to Lender at the Default Rate subject to the provisions of the Subordination Agreement. All such sums advanced by Lender, with interest thereon, immediately upon advancement thereof, shall be deemed to be part of Borrower’s Obligations.

**ARTICLE VIII**

**EXPENSES AND INDEMNITY**

8.1 Attorneys’ Fees and Other Fees and Expenses. Each of the Parties shall bear its own expenses in connection with the preparation of this Loan Agreement and the Note and transactions contemplated hereby and in connection with any amendments, modifications or waivers under or in respect of any of the Loan Instruments. Upon consummation of the transactions contemplated hereby, Borrower shall reimburse Lender for reasonable legal fees and out-of-pocket expenses in connection with the preparation of the Loan Instruments and transactions contemplated hereby, up to a maximum of $250,000, less $50,000 previously advanced by Borrower to Lender.

8.2 Indemnity. Borrower agrees to indemnify and save Lender harmless of and from, subject to the provisions of the Subordination Agreement, the following:

8.2.1 Fees and Expenses in Enforcement of Rights or Defense of Loan Instruments. Any reasonable expenses or other costs, including reasonable attorneys’ fees and expert witness fees, actually incurred by Lender in connection with the enforcement of or collection against any Obligor of any provision of any of the Loan Instruments, and in connection with or arising out of any litigation, investigation or proceeding instituted by any Governmental Body or any other Person with respect to any of the Loan Instruments, whether or not suit is instituted, including, but not limited to, such costs or expenses arising from the enforcement or collection against any Obligor of any provision of any of the Loan Instruments in any state or federal bankruptcy or reorganization proceeding.

8.2.2 General. Any loss, cost, liability, damage or expense (including reasonable attorneys’ fees and expenses) incurred by Lender and deemed reasonably necessary by Lender with respect to investigating, preparing for, defending against, providing evidence, producing documents or taking other action in respect of any commenced or threatened litigation, administrative proceeding, suit instituted by any Person or investigation under any law, including any federal securities law, the Bankruptcy Code, any relevant state corporate statute or any other securities law, bankruptcy law or law affecting creditors generally of any jurisdiction, or any regulation pertaining to any of the foregoing, or at com-
mon law or otherwise, relating to the transactions contemplated by or referred to in, or any other matter related to, the Loan Instruments, whether or not Lender is a party to such litigation, proceeding or suit, or is subject to such investigation; provided, however, that the foregoing indemnity shall not apply (i) to litigation commenced by the Borrower against the Lenders, any Assignee or the Agent which seeks enforcement of any of the rights of the Borrower or Obligors hereunder or under any Loan Instrument and is determined adversely to the Lenders, any Assignee or the Agent in a final, non-appealable judgment or a judgment not appealed by the Lenders, any Assignee or the Agent, or (ii) to the extent such claims, damages, liabilities and expenses result from the gross negligence or willful misconduct of the Lenders, any Assignee or the Agent.

8.2.3 Environmental Indemnity. Any and all claims, losses, damages, out of pocket response costs, clean-up costs and expenses suffered and/or incurred at any time by Lender arising out of or in any way relating to the existence at any time of any Hazardous Materials in, on, under, at, transported to or from, or used in the construction and/or renovation of, any of the Leasehold Property, any parcel of real estate acquired in connection with an acquisition, or otherwise with respect to any Environmental Law, and/or the failure of any Obligor to perform its obligations and covenants hereunder with respect to environmental matters, including, but not limited to: (i) claims of any Persons for damages, penalties, response costs, clean-up costs, injunctive or other relief, (ii) costs of removal and restoration, including fees of attorneys and experts, and costs of reporting the existence of Hazardous Materials to any Governmental Body, and (iii) any expenses or obligations, including reasonable attorneys' fees and expert witness fees, incurred at, before and after any trial or other proceeding before any Governmental Body or appeal therefrom whether or not taxable as costs, including, without limitation, witness fees, deposition costs, copying and telephone charges and other expenses, all of which shall be paid by Borrower to Lender when incurred by Lender, except where such costs were directly caused by the gross negligence or willful misconduct of Lender, or by a third party acting on behalf of and at the direction of Lender.

ARTICLE IX

OPERATIONS; AGENT

9.1 Agent's Authority to Act. Each of the Lenders appoints and authorizes _________ to act for the Lenders as the Lenders' Agent in connection with the transactions contemplated by this Loan Agreement and the other Loan Instruments on the terms set forth herein. All action in connection with the enforcement of, or the exercise of any remedies (other than the Lenders' rights of set-off as provided in any Loan Instrument) in respect of the Borrower's Obligations to Lenders and Loan Instruments shall be taken by the Agent.

9.2 Reliance of Borrower on Agent. The Borrower and each Obligor shall be fully protected in making all payments in respect of Borrower's Obligations to Lenders to the Agent, in relying upon consents, modifications and amendments
executed by the Agent purportedly on the Lenders’ behalf, and in dealing with the Agent as herein provided.

9.3 Agent to Allocate Payments. All payments of principal and interest in respect of the extensions of credit made pursuant to this Loan Agreement, Facility Fees and other fees under this Loan Agreement shall, as a matter of convenience, be made by the Borrower and the Guarantors to the Agent in immediately available funds by noon (New York time) on any Business Day. The share of each Lender shall be credited to such Lender by the Agent in immediately available funds by 2:00 p.m. (New York time) on such Business Day in such manner that the principal amount of the Borrower’s Obligations to Lenders to be paid shall be paid proportionately in accordance with the Lenders’ respective Percentage Interests in such Borrower’s Obligations to Lenders, except as otherwise provided in this Loan Agreement. Under no circumstances shall any Lender be required to produce or present its Notes as evidence of its interests in the Borrower’s Obligations to Lenders in any action or proceeding relating to the Borrower’s Obligations to Lenders.

9.4 Sharing of Payments. Each Lender agrees that (i) if by exercising any right of set-off or counterclaim or otherwise, it shall receive payment of (a) a proportion of the aggregate amount due with respect to its Percentage Interest in the Loan which is greater than (b) the proportion received by any other Lender in respect of the aggregate amount due with respect to such other Lender’s Percentage Interest in the Loan, and (ii) if such inequality shall continue for more than ten days, the Lender receiving such proportionately greater payment shall purchase participations in the Percentage Interests in the Loan held by other Lenders, and such other adjustments shall be made from time to time (including rescission of such purchases of participations in the event the unequal payment originally received is recovered from such Lender through bankruptcy proceedings or otherwise), as may be required so that all such payments of principal and interest with respect to the Loan held by the Lenders shall be shared by the Lenders pro rata in accordance with their respective Percentage Interests; provided, however, that this Section 9.4 shall not impair the right of any Lender to exercise any right of set-off or counterclaim it may have and to apply the amount subject to such exercise to the payment of Indebtedness of any Obligor other than such Obligor’s Indebtedness with respect to the Loan. The provisions of this Section 9.4 are for the sole and exclusive benefit of the Lenders and no failure of any Lender to comply with the terms hereof shall be available to any Obligor as a defense to the payment of the Borrower’s Obligations to Lenders.

9.5 Rights as a Lender. With respect to any credit extended it hereunder, ________ shall have the same rights, obligations and powers hereunder as any other Lender and may exercise such rights and powers as though it were not the Agent, and unless the context otherwise specifies, ________ shall be treated in its individual capacity as though it were not the Agent hereunder. Without limiting the generality of the foregoing, the Percentage Interest of ________ shall be included in any computations of Percentage Interests. ________ and its Affiliates may accept deposits from, lend money to, act as trustee for and generally engage in any kind of commercial lending or trust business with the Obligors
or any Affiliate of any of them and any Person who may do business with or own an equity interest in the Obligors or any Affiliate of any of them, all as if were not the Agent and without any duty to account therefor to the other Lenders.

9.6 Register. The Register shall include the names and addresses of the Lenders and the Assignees which assume rights and obligations pursuant to an assignment hereunder, and the amount of the Loan owing to each Lender from time to time. The entries in the Register shall be conclusive, in the absence of manifest error, and the Borrower, the Agent and the Lenders may treat each Person whose name is registered therein for all purposes as a party to this Loan Agreement. The Register shall be available for inspection by the Borrower or any Lender at any reasonable time and from time to time upon reasonable prior notice.

9.7 Agent's Resignation. The Agent may resign at any time by giving at least 60 days' prior written notice of its intention to do so to each of the Lenders and the Borrower and upon the appointment by the Lenders of a successor Agent reasonably satisfactory to the Borrower. If no successor Agent shall have been so appointed and shall have accepted such appointment within 45 days after the retiring Agent's giving of such notice of resignation, then the retiring Agent may with the consent of the Borrower, which shall not be unreasonably withheld, appoint a successor Agent which shall be a bank or a trust company organized under the laws of the United States of America or any state thereof and having a combined capital, surplus and undivided profit of at least $200,000,000; provided, however, that any successor Agent appointed under this sentence may be removed upon the written request of the Lenders, which request shall also appoint a successor Agent reasonably satisfactory to the Borrower. Upon the appointment of a new Agent hereunder, the term "Agent" shall for all purposes of this Loan Agreement thereafter mean such successor. After any retiring Agent's resignation hereunder as Agent, or the removal hereunder of any successor Agent, the provisions of this Loan Agreement shall continue to inure to the benefit of such retiring or removed Agent as to any actions taken or omitted to be taken by it while it was Agent under this Loan Agreement.

9.8 Concerning the Agent.

9.8.1 Action in Good Faith. The Agent and its officers, directors, employees and agents shall be under no liability to any of the Lenders or to any future holder of any interest in the Borrower's Obligations to Lenders for any action or failure to act taken or suffered in good faith, and any action or failure to act in accordance with an opinion of its counsel shall conclusively be deemed to be in good faith. The Agent shall in all cases be entitled to rely, and shall be fully protected in relying, on instructions given to the Agent by the Lenders.

9.8.2 No Implied Duties, etc. The Agent shall have and may exercise such powers as are specifically delegated to the Agent under this Loan Agreement or any other Loan Instrument together with all other powers incidental thereto. The Agent shall have no implied duties to any Person or any obligation to take any action under this Loan Agreement or any other Loan Instrument
except for action specifically provided for in this Loan Agreement or any other Loan Instrument to be taken by the Agent.

9.8.3 **Validity, etc.** The Agent shall not be responsible to any Lender or any future holder of any interest in the Borrower's Obligations to Lenders (a) for the legality, validity, enforceability or effectiveness of this Loan Agreement or any other Loan Instrument, (b) for any recitals, reports, representations, warranties or statements contained in or made in connection with this Loan Agreement or any other Loan Instrument, (c) for the existence or value of any assets included in any security for the Borrower's Obligations to Lenders, (d) for the effectiveness of any Lender's Lien, (e) for the specification or failure to specify any particular assets to be subjected to a Lender's Lien.

9.8.4 **Compliance.** The Agent shall not be obligated to ascertain or inquire as to the performance or observance of any of the terms of this Loan Agreement or any other Loan Instrument; and in connection with any extension of credit under this Loan Agreement or any other Loan Instrument, the Agent shall be fully protected in relying on a certificate of the Borrower as to the fulfillment by the Borrower of any conditions to such extension of credit.

9.8.5 **Employment of Agents and Counsel.** The Agent may execute any of its duties as Agent under this Loan Agreement or any other Loan Instrument by or through employees, agents and attorneys-in-fact and shall not be responsible to any of the Lenders, the Borrower or any other Obligor for the default or misconduct of any such agents or attorneys-in-fact selected by the Agent acting in good faith. The Agent shall be entitled to advice of counsel concerning all matters pertaining to the agency hereby created and its duties hereunder or under any other Loan Instrument.

9.8.6 **Reliance on Documents and Counsel.** The Agent shall be entitled to rely, and shall be fully protected in relying, upon any affidavit, certificate, cablegram, consent, instrument, letter, notice, order, document, statement, telecopy, telegram, telex or teletype message or writing reasonably believed in good faith by the Agent to be genuine and correct and to have been signed, sent or made by the Person in question, including any telephonic or oral statement made by such Person, and, with respect to legal matters, upon an opinion or the advice of counsel selected by the Agent.

9.8.7 **Agent's Reimbursement.** Each of the Lenders severally agrees to reimburse the Agent, pro rata in accordance with such Lender's Percentage Interest, for any reasonable expenses not reimbursed by the Obligors (without limiting the obligation of the Obligors to make such reimbursement): (a) for which the Agent is entitled to reimbursement by the Obligors under this Loan Agreement or any other Loan Instrument, and (b) after the occurrence of a Default, for any other reasonable expenses incurred by the Agent on the Lenders' behalf in connection with the enforcement of the Lenders' rights under this Loan Agreement or any other Loan Instrument; provided, however, that the Agent shall not be reimbursed for any such expenses arising as a result of its gross negligence or willful misconduct.
9.9 Independent Credit Decision. Each of the Lenders acknowledges that it has independently and without reliance upon the Agent, based on the financial statements and other documents referred to in Section 3.16, on the other representations and warranties contained herein and on such other information with respect to the Borrower and its Subsidiaries as such Lender deemed appropriate, made such Lender’s own credit analysis and decision to enter into this Loan Agreement and to make the extensions of credit provided for hereunder. Each Lender represents to the Agent that such Lender will continue to make its own independent credit and other decisions in taking or not taking action under this Loan Agreement or any other Loan Instrument. Each Lender expressly acknowledges that neither the Agent nor any of its officers, directors, employees, agents, attorneys-in-fact or Affiliates has made any representations or warranties to such Lender, and no act by the Agent taken under this Loan Agreement or any other Loan Instrument, including any review of the affairs of the Borrower and its Subsidiaries, shall be deemed to constitute any representation or warranty by the Agent. Except for notices, reports or other documents expressly required to be furnished to each Lender by the Agent under this Loan Agreement or any other Loan Instrument, the Agent shall not have any duty or responsibility to provide any Lender with any credit or other information concerning the business, operations, property, condition, financial or otherwise, or creditworthiness of either Borrower or any Subsidiary which may come into the possession of the Agent or any of its officers, directors, employees, agents, attorneys-in-fact or Affiliates.

9.10 Indemnification. The Lenders shall severally indemnify the Agent and its officers, directors, employees, agents, attorneys, accountants, consultants and controlling Persons (to the extent not reimbursed by the Obligors and without limiting the obligation of any of the Obligors to do so), pro rata in accordance with their respective Percentage Interest, from and against any and all liabilities, obligations, losses, damages, penalties, actions, judgments, suits, costs, expenses or disbursements of any kind whatsoever which may at any time be imposed on, incurred by or asserted against the Agent or such Persons relating to or arising out of this Loan Agreement, any other Loan Instrument, the transactions contemplated hereby or thereby, or any action taken or omitted by the Agent in connection with any of the foregoing; provided, however, that the foregoing shall not extend to actions or omissions which are taken by the Agent constituting gross negligence or willful misconduct.

9.11 Successors and Assigns; Lender Assignments and Participations. Any reference in this Loan Agreement or any other Loan Instrument to any of the parties hereto shall be deemed to include the successors and assigns of such party, and all covenants and agreements by or on behalf of Borrower, the other Obligors, the Agent or the Lenders that are contained in this Loan Agreement of any other Loan Instrument shall bind and inure to the benefit of their respective successors and assigns; provided, however, that (a) the Borrower and its respective Subsidiaries may not assign their rights or obligations under this Loan Agreement or any other Loan Instrument except for permitted Liquidity Events, and (b) the Lenders shall not be entitled to assign their respective Percentage Interest in the credits extended hereunder or their Commitments except as set
forth below in this Section 9, and (c) the Agent shall not make an assignment pursuant to this Section 9 if, as a result thereof, the Agent would hold less than 51% of the Percentage Interests in the total Commitments at the time in effect and reflected in the Register.

9.12 Assignments by Lenders.

9.12.1 Assignees and Assignment Procedures. Each Lender may (a) without the consent of the Agent if the proposed Assignee is either (x) an existing Lender, (y) the parent company of any Lender, or (z) an Affiliate of a Lender that is at least 50% owned by such Lender or by the parent company of such Lender, or (b) otherwise, with the consent of the Agent, and with the consent of the Borrower (which shall not be unreasonably withheld or delayed), in compliance with applicable laws in connection with such assignment, assign to one or more commercial banks, investment companies, other financial institutions or mutual funds (each, an "Assignee") all or a portion of its interests, rights and obligations under this Loan Agreement and the other Loan Instruments; provided, however, that the parties to each such assignment shall execute and deliver to the Agent an Assignment and Acceptance (the "Assignment and Acceptance") substantially in the form of Exhibit 9.12.1, together with the Note subject to such assignment and a processing and recordation fee of $3,100 payable to the Agent by the assigning Lender or the Assignee. Upon acceptance and recording pursuant to Section 9.12.3, from and after the effective date specified in each Assignment and Acceptance (which effective date shall, unless waived by the Agent, be at least five Business Days after receipt of the executed Assignment and Acceptance by the Agent, together with the assignment fee referenced below):

(a) the Assignee shall be party hereto and, to the extent provided in such Assignment and Acceptance, have the rights and obligations of a Lender under this Loan Agreement and

(b) the assigning Lender shall, to the extent provided in such assignment, be released from its obligations under this Loan Agreement (and, in the case of an Assignment and Acceptance covering all or the remaining portion of an assigning Lender's rights and obligations under this Loan Agreement, such Lender shall cease to be a party hereto but shall continue to be entitled to the benefits of Article VIII, as well as to any fees accrued for its account hereunder and not yet paid).

9.12.2 Terms of Assignment and Acceptance. By executing and delivering an Assignment and Acceptance, the assigning Lender and Assignee shall be deemed to conform to and agree with each other an the other parties here- to as follows:

(a) other than the representation and warranty that it is the legal and beneficial owner of the interest being assigned thereby free and clear of any adverse claim, such assigning Lender makes no representation or warranty and assumes no responsibility with respect to any statements, warranties or representations made in or in connection with this Loan Agreement or the execution, legality, validity, enforceability, genuineness, sufficiency or value of
this Loan Agreement, any other Loan Instrument or any other instrument or document furnished pursuant hereto;

(b) such assigning Lender makes no representation or warranty and assumes no responsibility with respect to the financial condition of either Borrower or its respective Subsidiaries or of any Guarantor or the performance or observance by the Borrower or any of its Subsidiaries or any Guarantor of any of its obligations under this Loan Agreement, and other Loan Instrument or any other instrument or document furnished pursuant hereto;

(c) such Assignee confirms that it has received a copy of this Loan Agreement, together with copies of the most recent financial statements delivered pursuant to Section 4.3 and such other documents and information as its has deemed appropriate to make its own credit analysis and decision to enter into such Assignment and Acceptance.

(d) such Assignee will independently and without reliance upon the Agent, such assigning Lender or any other Lender, and based on such documents and information as its shall deem appropriate at the time, continue to make its own credit decisions in taking or not taking action under this Loan Agreement;

(e) such Assignee appoints and authorizes the Agent to take such action as agent on its behalf and to exercise such powers under this Loan Agreement as are delegated to the Agent by the terms hereof, together with such powers as are reasonably incidental thereto; and

(f) such Assignee agrees that it will perform in accordance with the terms of this Loan Agreement all the obligations which are required to be performed by it as a Lender.

9.12.3 **Acceptance of Assignment and Assumption.** Upon its receipt of a completed Assignment and Acceptance executed by an assigning Lender and an Assignee (and any necessary consent of the Agent) together with the Note subject to such assignment, and the processing and recordation fee referred to in Section 9.12.1, the Agent shall (a) accept such Assignment and Acceptance, (b) record the information contained therein in the Register, and (c) give prompt notice thereof to the Borrower. Within five Banking Days after receipt of notice, the Borrower, at its own expense, shall execute and deliver to the Agent, in exchange for the surrendered Note, a new Note to the order of such Assignee in a principal amount equal to the applicable Commitment and Loan assumed by it pursuant to such Assignment and Acceptance and, if the assigning Lender has retained a Commitment and Loan, a new Note to the order of such assigning Lender in a principal amount equal to the applicable Commitment and Loan retained by it. Such new Note shall be in an aggregate principal amount equal to the aggregate principal amount of such surrendered Note, and shall be dated the date of the surrendered Note which it replaces.

9.13 **Further Assurances.** Each Borrower and their respective Subsidiaries and any Guarantor shall sign such documents and take such other
actions from time to time reasonably requested by an Assignee to enable it to share in the benefits of the rights created by the Loan Instruments.

9.14 Confidentiality. Each Lender will make no disclosure of confidential information furnished to it be Borrower or any of its Subsidiaries unless such information shall have become public other than as a result of any Lender's breach of this Section 9.14, except:

(a) in connection with operations under or the enforcement of this Loan Agreement or any other Loan Instrument to Persons who have a reasonable need to be furnished such confidential information and who agree to comply with the restriction contained in this Section 9.14 with respect to such information;

(b) pursuant to any statutory or regulatory requirement or any mandatory court order, subpoena or other legal process;

(c) to any parent or corporate Affiliate of such Lender or to any Credit Participant, proposed Credit Participant or proposed Assignee; provided, however, that any such Person shall agree to comply with the restrictions set forth in this Section 9.14 with respect to such information;

(d) to its independent counsel, auditors and other professional advisors with an instruction to such Person to keep such information confidential;

(e) with the prior written consent of Borrower, to any other Person; and

(f) in compliance with Section 11.2 of this Loan Agreement.

9.15 Restrictions on Assignment and Assumption. Notwithstanding any language to the contrary set forth elsewhere in this Article IX, none of the Lenders, the Agent, or any Assignee will:

(a) transfer or assign any interest in the Loan without providing ten days’ prior written notice to Borrower of such transfer, assignment or assumption;

(b) transfer or assign any interest in the Loan to an entity engaged in a Competitive Business; and

(c) transfer or assign any interest in the Loan to any other Assignee that owns or has the right to acquire five percent (5%) of any entity that is engaged in a Competitive Business.

9.16 Amendments, Consents, Waivers, etc.

9.16.1 Lender Consents for Amendments. Except as otherwise set forth herein, the Agent may (and upon the written request of the Lenders the Agent shall) take or refrain from taking any action under this Agreement or any other Loan Instrument, including giving its written consent to any modification of or amendment to and waiving in writing compliance with any covenant or condition in this Agreement or any other Loan Instrument or any Default or Event of Default, all of which actions shall be binding upon all of the Lenders; provided, however, that:
(a) Except as provided below, without the written consent of the Lenders owning at least a majority of the Percentage Interests, no written modification of, amendment to, consent with respect to, waiver of compliance with or waiver of a Default under, any of the Loan Instruments shall be made.

(b) Without the written consent of such Lenders as own 100% of the Percentage Interests:

(i) No reduction shall be made in (A) the amount of principal of the Loan, (B) the interest rate on the Loan (other than amendments and waivers approved by the Lenders that waive an increase in the Interest Rate to the Default Rate as a result of an Event of Default), or (C) Facility Fees with respect to the Loan provided herein;

(ii) No change shall be made in the stated, scheduled time of payment of all or any portion of the Loan or interest thereon or fees relating to any of the foregoing payable to all of the Lenders and no waiver shall be made of any Default;

(iii) No increase shall be made in the amount, or extension of the term, of the stated Commitments beyond that provided for in this Loan Agreement and the Note and as set forth in the Register;

(iv) No alteration shall be made of any Lenders’ rights of set-off;

(v) No release of all or a material portion of the Borrower or any Obligor shall be made (in any event, without the written consent of the Lenders, the Agent may release particular Obligors in dispositions permitted by Section 4.24, as modified by amendments thereto approved by the Lenders);

(vi) No amendment to or modification of this Section 9.16 or the definition of “Lenders” shall be made; and

(vii) No change shall be made in the allocation of prepayments among Lenders made by Borrower under Section 2.5 of this Loan Agreement.

(c) Without the written consent of the Agent, no amendment or modification of any Loan Instrument shall affect the rights or duties of the Agent under the Loan Instruments.

9.16.2 Course of Dealing; No Implied Waivers. No course of dealing between any Lender or the Agent, on one hand, and the Borrower or any other Obligor, on the other hand, shall operate as a waiver of any of the Lenders’ or the Agent’s rights under this Agreement or any other Loan Instrument or with respect to the Borrower’s Obligations to Lender. In particular, no delay or omission on the part of any Lender or the Agent in exercising any right under this Agreement or any other Loan Instrument or with respect to the Borrower’s Obligations to Lender shall operate as a waiver of such right or any other right hereunder or thereunder. A waiver on any one occasion shall not be construed as
a bar to or waiver of any right or remedy on any future occasion. No waiver, consent or amendment with respect to this Agreement or any other Loan Instrument shall be binding unless it is in writing and signed by the Agent or the Lenders.

ARTICLE X

CLOSING

10.1 Conditions to Extending Credit. The obligations of the Lenders to make the extension of credit pursuant to Section 2 of this Loan Agreement shall be subject to the satisfaction, on or before the Closing Date, of the conditions set forth in this Section 10.1.

10.1.1 Note. The Borrower shall have duly executed and delivered to the Agent a Note for each Lender having a Percentage Interest in the Loan.

10.1.2 Payment of Fees. The Borrower shall have executed payment instructions under which the Agent shall be entitled to receive the Facility Fee and reimbursement of expenses described in Section 8.1 at Closing.

10.1.3 Legal Opinions. The Agent shall have received from the following counsel their respective opinions with respect to the transactions contemplated by the Loan Instruments, which opinions shall be in form and substance reasonably satisfactory to the Agent:

Berliner Zisser Walter & Gallegos, P.C., counsel for Borrower and its Subsidiaries.

10.1.4 Proper Proceedings. This Loan Agreement, each other Loan Instrument and the transactions contemplated hereby and thereby shall have been authorized by all necessary corporate or other proceedings. All necessary consents, approvals and authorizations of any governmental or administrative agency or any other Person of any of the transactions contemplated hereby or by any other Loan Instrument shall have been obtained and shall be in full force and effect.

10.1.5 General. The Agent shall have received copies of all documents, including certified copies of the Certificate of Incorporation and By-Laws of Borrower and the other Obligors, records of corporate proceedings, certificates as to signatures and incumbency of officers and opinions of counsel, which the Agent may have reasonably requested in connection therewith, such documents where appropriate to be certified by proper corporate or governmental authorities.

ARTICLE XI

MISCELLANEOUS

11.1 Notices. All notices and communications under this Loan Agreement shall be in writing and shall be (i) delivered in person, (ii) sent by confirmed facsimile, or (iii) mailed, postage prepaid, either by registered or certified mail,
return receipt requested, or by overnight express carrier, addressed in each case as follows:

To Borrower: Borrower

__________________________

__________________________

__________________________

With a copy to: Robert W. Walter, Esq.
Berliner Zisser Walter & Gallegos, P.C.
1700 Lincoln Street, Suite 4700
Denver, Colorado 80203
Telephone: (303) 830-1700
Facsimile: (303) 830-1705

To Lender:__________________________

__________________________

__________________________

With a copy to: Lender’s Attorney

__________________________

__________________________

or to any other address or facsimile number, as to any of the Parties hereto, as such party shall designate in a written notice to the other Parties hereto. All notices sent pursuant to the terms of this Section 11.1 shall be deemed received (i) if personally delivered, then on the Business Day of delivery, (ii) if sent by facsimile before 2:00 p.m. eastern time, on the day sent if a Business Day or if such day is not a Business Day or if sent after 2:00 p.m. eastern time, then on the next Business Day, (iii) if sent by overnight, express carrier, on the next Business Day immediately following the day sent, or (iv) if sent by registered or certified mail, on the earlier of the fifth Business Day following the day sent or when actually received. Any notice by facsimile shall be followed by delivery on the next Business Day by overnight, express carrier or by hand. Any notice to Lenders other than the Agent, or to Assignees, shall be sent to the address set forth in Section 11.1 of this Loan Agreement and, upon receipt thereof, the Agent shall
provide required copies of any such notices to Lenders and Assignees at the address set forth in the Register.

11.2 Confidentiality and Non-Disclosure. Lender does hereby covenant and agree with Borrower as follows:

11.2.1 Non-disclosure. Lender shall keep strictly confidential and shall not disclose, or cause or permit to be disclosed, to any person or entity, (i) any information about Borrower or the fact that Lender has received the Confidential Information except that Lender may make such disclosure if it has received the written opinion of its outside counsel that such disclosure must be made in order that Lender not commit a violation of law, and (ii) the Confidential Information, except to those officers, employees or other authorized agents and representatives of Lender to whom disclosure is reasonably necessary and who shall agree to be bound by the terms of this Loan Agreement, and except as otherwise consented to in writing by Borrower. Lender shall take all actions reasonably necessary to ensure that the Confidential Information remains strictly confidential and is not disclosed to or seen, used or obtained by any person or entity except in accordance with the terms of this Loan Agreement. Lender agrees not to contact any employees, customers, or suppliers of Borrower or its affiliates for the purpose of obtaining information without Borrower's prior written consent.

In the event that Lender is requested or required (by oral questions, interrogatories, requests for information or documents in legal proceedings, subpoena, civil investigative demand or other similar process) to disclose any of the Confidential Information, Lender shall provide Borrower with prompt written notice of any such request or requirement so that Borrower may seek a protective order or other appropriate remedy and/or waive compliance with the provisions of this Loan Agreement. If, in the absence of a protective order or other remedy or the receipt of a waiver by Borrower, Lender is nonetheless, in the written opinion of its outside counsel, legally compelled to disclose Confidential Information to any tribunal or else stand liable for contempt or suffer other censure or penalty, Lender may, without liability hereunder, disclose to such tribunal only that portion of the Confidential Information which such counsel advises Lender is legally required to be disclosed, provided that Lender shall use its best efforts to preserve the confidentiality of the Confidential Information, including, without limitation, by cooperating with Borrower to obtain an appropriate protective order or other reliable assurance that confidential treatment will be afforded the Confidential Information by such tribunal.

11.2.2 Ownership. The Confidential Information is owned solely and exclusively by Borrower, shall remain the exclusive property of Borrower, and Lender shall have no right, title or interest in or to any of the Confidential Information or any material developed therefrom.

11.2.3 Use. Lender shall use or cause the Confidential Information to be used only in a manner consistent with the terms and conditions of this Loan Agreement and at no time shall Lender otherwise use the Confidential Information for the benefit of itself or any other third party or in any manner
adverse to, or to the detriment of, Borrower or its affiliates or their respective shareholders.

11.2.4 Other Parties Bound. All affiliates of Lender and all directors, officers, employees, agents and representatives of Lender or its affiliates shall be included within the definition of the term "Lender" for purposes of this Section 11.2 and shall be bound by the terms and conditions of this Loan Agreement. Lender shall be responsible for any breaches of this Section 11.2 by any of its affiliates and any directors, officers, employees, agents and representatives of Lender or its affiliates.

11.2.5 Return of Confidential Information. Lender shall, upon repayment of the Loan, immediately return to Borrower upon Borrower's written request all Confidential Information (including notes, writings and other material developed therefrom by Lender) and all copies thereof and retain none for its files. Notwithstanding such return, Lender shall continue to be bound by this Section 11.2.

11.2.6 Indemnification. Lender shall indemnify and hold harmless Borrower and its affiliates and their respective directors, officers, employees, agents and representatives from and against any and all losses, damages, costs and expenses (including, without limitation, reasonable attorneys' fees and expenses) caused by or arising out of any breach of this Section 11.2 by Lender or any breach for which Lender is responsible hereunder, and any and all actions, suits, proceedings, claims, demands or judgments incident thereto.

11.2.7 Equitable Remedies. Lender hereby agrees that its failure to perform any obligation or duty which it has agreed to perform under this Section 11.2 will cause irreparable harm to Borrower, which harm cannot be adequately compensated for by money damages. It is further agreed by Lender that an order of specific performance or for injunctive relief against Lender in the event of a breach or default under the terms of this Section 11.2 would be equitable and would not work a hardship on Lender. Accordingly, in the event of a breach or default by Lender hereunder, Borrower, without any bond or other security being required and in addition to whatever other remedies are or might be available at law or in equity, shall have the right either to compel specific performance by, or to obtain injunctive relief against, Lender, with respect to any obligation or duty herein or breach thereof.

11.2.8 No Licenses Granted. Borrower grants no licenses, by implication or otherwise, under any patent, copyright, trademark, trade secret or other rights by disclosing Confidential Information under or in connection with this Loan Agreement.

11.2.9 Trading in Securities. Lender acknowledges that it is aware, and agrees to advise its directors, officers, employees, agents and representatives who are informed as to the matters which are the subject of this Loan Agreement, that the United States securities laws prohibit any person who has material, non-public information from purchasing or selling securities of a company that may be a party to such Loan Agreement or from communicating such information to any
other person under circumstances in which it is reasonably foreseeable that such person is likely to purchase or sell such securities.

11.3 Survival of Loan Agreement; Indemnities. All covenants, agreements, representations and warranties made in this Loan Agreement shall survive the making by Lender of the Loan and the execution and delivery to Lender of the Note and of all other Loan Instruments, and shall continue in full force and effect so long as any of Borrower's Obligations remain outstanding, unperfomed or unpaid. Notwithstanding the repayment of all amounts due under the Loan Instruments, the cancellation of the Note and the release and/or cancellation of any and all of the Loan Instruments, the obligations of Borrower to indemnify Lender with respect to the expenses, damages, losses, costs and liabilities described in Section 8.2 shall survive until all applicable statute of limitations periods with respect to actions which may be brought against Lender have run.

11.4 Further Assurance. From time to time, Borrower shall execute and deliver to Lender such additional documents as Lender reasonably may require to carry out the purposes of the Loan Instruments and to protect Lender's rights thereunder, and not take any action inconsistent with the purposes of the Loan Instruments.

11.5 Taxes and Fees. Should any tax (other than taxes based upon the net income of Lender), recording or filing fees become payable in respect of any of the Loan Instruments, or any amendment, modification or supplement thereof, Borrower agrees to pay the same on demand, together with any interest or penalties thereon attributable to any delay by Borrower in meeting Lender's demand, and agree to hold Lender harmless with respect thereto.

11.6 Severability. In the event that any provision of this Loan Agreement is deemed to be invalid by reason of the operation of any law, this Loan Agreement shall be construed as not containing such provision and the invalidity of such provision shall not affect the validity of any other provisions hereof, and any and all other provisions hereof which otherwise are lawful and valid shall remain in full force and effect.

11.7 Waiver. No delay on the part of Lender in exercising any right, power or privilege hereunder shall operate as a waiver thereof, and no single or partial exercise of any right, power or privilege hereunder shall preclude other or further exercise thereof, or be deemed to establish a custom or course of dealing or performance between the Parties hereto, or preclude the exercise of any other right, power or privilege.

11.8 Modification of Loan Instruments. No modification or waiver of any provision of any of the Loan Instruments shall be effective unless the same shall be in writing, and then such waiver or consent shall be effective only in the specific instance and for the purpose for which given. No notice to or demand on Borrower in any case shall entitle Borrower to any other or further notice or demand in the same, similar or other circumstances.
11.9 Captions. The headings in this Loan Agreement are for purposes of reference only and shall not limit or otherwise affect the meaning hereof.

11.10 Successors and Assigns. This Loan Agreement shall be binding upon and inure to the benefit of and be enforceable by the respective successors and permitted assigns of the Parties hereto.

11.11 Remedies Cumulative. All rights and remedies of Lender pursuant to this Loan Agreement, any other Loan Instruments or otherwise, shall be cumulative and non-exclusive, and may be exercised singularly or concurrently.

11.12 Entire Agreement; Conflict. This Loan Agreement and the other Loan Instruments executed pursuant hereto constitute the entire agreement among the Parties hereto with respect to the transactions contemplated hereby or thereby and supersede any prior agreements, whether written or oral, relating to the subject matter hereof. In the event of a conflict between the terms and conditions set forth herein and the terms and conditions set forth in any other Loan Instrument, the terms and conditions set forth herein shall govern.

11.13 APPLICABLE LAW. THE LOAN INSTRUMENTS SHALL BE CONSTRUED IN ACCORDANCE WITH AND GOVERNED BY THE LAWS AND DECISIONS OF THE STATE OF DELAWARE. FOR PURPOSES OF THIS SECTION 11.13, THE LOAN INSTRUMENTS SHALL BE DEEMED TO BE PERFORMED AND MADE IN THE STATE OF DELAWARE.

11.14 JURISDICTION AND VENUE. BORROWER HEREBY AGREES THAT ALL ACTIONS OR PROCEEDINGS INITIATED BY BORROWER AND ARISING DIRECTLY OR INDIRECTLY OUT OF THE LOAN INSTRUMENTS SHALL BE LITIGATED IN THE COURTS OF DELAWARE, OR THE UNITED STATES DISTRICT COURT SITTING IN DELAWARE. BORROWER HEREBY EXPRESSLY SUBMITS AND CONSENTS IN ADVANCE TO SUCH JURISDICTION IN ANY ACTION OR PROCEEDING COMMENCED BY LENDER IN ANY OF SUCH COURTS, AND HEREBY AGREES THAT PERSONAL SERVICE OF THE SUMMONS AND COMPLAINT, OR OTHER PROCESS OR PAPERS ISSUED THEREIN MAY BE SERVED IN THE MANNER PROVIDED FOR NOTICES HEREIN, AND AGREES THAT SERVICE OF SUCH SUMMONS AND COMPLAINT OR OTHER PROCESS OR PAPERS MAY BE MADE BY REGISTERED OR CERTIFIED MAIL ADDRESSED TO BORROWER AT THE ADDRESS TO WHICH NOTICES ARE TO BE SENT PURSUANT TO SECTION 11.1. BORROWER WAIVES ANY CLAIM THAT THE STATE OF DELAWARE IS AN INCONVENIENT FORUM OR AN IMPROPER FORUM BASED ON LACK OF VENUE. TO THE EXTENT PROVIDED BY LAW, SHOULD BORROWER, AFTER BEING SO SERVED, FAIL TO APPEAR OR ANSWER TO ANY SUMMONS, COMPLAINT, PROCESS OR PAPERS SO SERVED WITHIN THE NUMBER OF DAYS PRESCRIBED BY LAW AFTER THE MAILING THEREOF, BORROWER SHALL BE DEEMED IN DEFAULT AND AN ORDER AND/OR JUDGMENT MAY BE ENTERED BY THE COURT AGAINST BORROWER AS DEMANDED OR PRAYED FOR IN SUCH SUMMONS, COMPLAINT, PROCESS OR PAPERS. THE EXCLUSIVE CHOICE OF FORUM FOR BORROWERS SET FORTH IN THIS SECTION 11.14 SHALL NOT BE DEEMED TO
PRECLUDE THE ENFORCEMENT BY LENDER OF ANY JUDGMENT OBTAINED IN ANY OTHER FORUM OR THE TAKING BY LENDER OF ANY ACTION TO ENFORCE THE SAME IN ANY OTHER APPROPRIATE JURISDICTION, AND BORROWER HEREBY WAIVES THE RIGHT TO COLLATERALLY ATTACK ANY SUCH JUDGMENT OR ACTION.

11.15 WAIVER OF RIGHT TO JURY TRIAL. LENDER AND BORROWER ACKNOWLEDGE AND AGREE THAT ANY CONTROVERSY WHICH MAY ARISE UNDER ANY OF THE LOAN INSTRUMENTS OR WITH RESPECT TO THE TRANSACTIONS CONTEMPLATED THEREBY WOULD BE BASED UPON DIFFICULT AND COMPLEX ISSUES AND, THEREFORE, THE PARTIES AGREE THAT ANY LAWSUIT ARISING OUT OF ANY SUCH CONTROVERSY WILL BE TRIED IN A COURT OF COMPETENT JURISDICTION BY A JUDGE SITTING WITHOUT A JURY.

11.16 Estoppel Certificate. Within 15 days after Lender reasonably requests the Borrower to do so, Borrower will execute and deliver to Lender a statement certifying (i) that this Loan Agreement is in full force and effect and has not been modified except as described in such statement, (ii) the date to which interest on the Note has been paid, (iii) the Principal Balance, (iv) whether or not to its knowledge an Incipient Default or Event of Default has occurred and is continuing, and, if so, specifying in reasonable detail each such Incipient Default or Event of Default of which it has knowledge, (v) whether to its knowledge it has any defense, setoff or counterclaim to the payment of the Note in accordance with its terms, and, if so, specifying each defense, setoff or counterclaim of which it has knowledge in reasonable detail (including where applicable the amount thereof), and (vi) as to any other matter reasonably requested by Lender.

11.17 Counterparts. This Loan Agreement may be executed by the Parties hereto in several counterparts and each such counterpart shall be deemed to be an original, but all such counterparts shall together constitute one and the same agreement.

11.18 No Fiduciary Relationship. No provision in this Loan Agreement or in any other Loan Instrument, and no course of dealing among the Parties hereto, shall be deemed to create any fiduciary duty by Lender to Borrower.

11.19 No Strict Construction. The language used in this Loan Agreement shall be deemed to be the language chosen by the Parties hereto to express their mutual intent, and no rule of strict construction shall be applied against any of the Parties hereto.

11.20 Conflict with Subordination Agreement. In the event of any conflict between any term, covenant or condition of this Loan Agreement or any other Loan Instrument and any term, covenant or condition of the Subordination Agreement, the provisions of the Subordination Agreement shall govern.

11.21 Application of Subordination Agreement. This entire Loan Agreement is subject to the provisions of the Subordination Agreement and the selective use herein of the phrase "subject to the provisions of the Subordination
Agreement" or phrases similar thereto shall not limit the application of the Subordination Agreement to any particular provision of this Loan Agreement or any other Loan Instrument.

IN WITNESS WHEREOF, this Loan Agreement has been executed and delivered by each of the Parties hereto by a duly authorized officer of each such party on this ___ day of ______, 2002, effective as of the date first written above.

BORROWER,

A ______ corporation

By: ________________________________

LENDER

By: ________________________________
APPENDIX M

INVESTORS’ RIGHTS AGREEMENT*

THIS INVESTORS’ RIGHTS AGREEMENT (the “Agreement”) is entered into as of this ___ day of ______, 2002, by and among ________, a __________ corporation (the “Company”) and the purchasers of Series A Preferred Stock (the “Series A Stock”) set forth on Exhibit A of that certain Series A Preferred Stock Purchase Agreement of even date herewith (the “Purchase Agreement”). The holders of Series A Stock who are parties hereto are set forth on Exhibit A hereto and shall be referred to hereinafter as the “Investors” and each individually as “Investor.”

RECITALS

WHEREAS, the Company proposes to sell and issue shares of Series A Stock pursuant to the Purchase Agreement; and

WHEREAS, as a condition to entering into the Purchase Agreement, the prospective purchasers have requested that the Company extend to them registration rights, information rights, preemptive rights and other rights as set forth below.

NOW, THEREFORE, in consideration of the mutual promises, representations, warranties, covenants and conditions set forth in this Agreement and in the Purchase Agreement, the parties mutually agree as follows:

SECTION 1. GENERAL

1.1 Definitions. As used in this Agreement the following terms shall have the following respective meanings:


* This agreement is intended as a sample only. It is included with the understanding that the publisher and author are not rendering legal or other professional services. It should not be used before the services of a competent legal professional have been obtained.
"Holder" means any person owning of record Shares or Registrable Securities that have not been sold to the public or any assignee of record of such Registrable Securities.

"Initial Public Offering" means the Company's first firm commitment underwritten public offering of its Common Stock registered under the Securities Act.

"Major Investor" shall mean a holder of Registrable Securities representing, together with the Registrable Securities held by any affiliated entity of such holder, at least 500,000 shares of Registrable Securities (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like).

"Qualified Public Offering" means the Company's first firm commitment underwritten public offering of its Common Stock registered under the Securities Act in which the valuation of all capital stock outstanding at the conclusion of the offering is at least $150,000,000, or a definitive agreement to purchase the Company exists in which the purchase price is at least $150,000,000.

"Registrable Securities" means (i) Common Stock of the Company issued or issuable upon conversion of the Shares and (ii) any Common Stock of the Company issued as (or issuable upon the conversion, right or other security which is issued) a dividend or other distribution with respect to, or in exchange for or in replacement of such above-described securities. Notwithstanding the foregoing, Registrable Securities shall not include any securities sold by a person to the public either pursuant to a registration statement or Rule 144 under the Securities Act or sold in a private transaction in which the transferor's rights under Section 2 of this Agreement are not assigned.

"Registrable Securities then Outstanding" shall be the number of shares determined by calculating the total number of shares of the Company's Common Stock that are Registrable Securities and (i) are then issued and outstanding, or (ii) are issuable pursuant to then exercisable or convertible securities.

"SEC" or "Commission" means the Securities and Exchange Commission.

"Securities Act" shall mean the Securities Act of 1933, as amended.

"Shares" shall mean the shares of the Company's Series A Preferred Stock issued pursuant to the certain Series A Stock Purchase Agreement, dated as of __________, 2002.

SECTION 2. REGISTRATION; RESTRICTIONS ON TRANSFER

2.1 Restrictions on Transfer.

(a) Each Holder agrees not to make any disposition of all or any portion of the Shares or Registrable Securities unless and until:

(i) There is then in effect a registration statement under the Securities Act covering such proposed disposition and such disposition is made in accordance with such registration statement; or
(ii) (A) The transferee has agreed in writing to be bound by the terms of this Agreement, and (B) such Holder shall have notified the Company of the proposed disposition and shall have furnished the Company with a detailed statement of the circumstances surrounding the proposed disposition, and (C) if requested by the Company, such Holder shall have furnished the Company with an opinion of counsel, reasonably satisfactory to the Company, or such other evidence that the Company may reasonably request, that such disposition will not result in a violation of the Securities Act.

(iii) Notwithstanding the provisions of paragraphs (i) and (ii) above, except in the case of unusual circumstances, no such registration statement or opinion of counsel shall be necessary for a transfer by a Holder which is (A) a partnership to its partners or former partners in accordance with partnership interests, (B) a corporation to its stockholders in accordance with their interest in the corporation, (C) a limited liability company to its members or former members in accordance with their interest in the limited liability company, or (D) to the Holder’s family member or trust for the benefit of an individual Holder, provided the transferee agrees to be subject to the terms of this Agreement to the same extent as if such transferee were an original Holder hereunder, and if requested by the Company, signs and delivers to the Company a counterpart to this Agreement.

(b) Each certificate representing Shares or Registrable Securities shall (unless otherwise permitted by the provisions of the Agreement) be stamped or otherwise imprinted with a legend substantially similar to the following (in addition to any legend required under applicable state securities laws or as provided elsewhere in this Agreement or any other agreement between the Company and the holder of such certificate):

THESE SECURITIES HAVE NOT BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933, NOR HAVE THEY BEEN REGISTERED UNDER THE SECURITIES (“BLUE SKY”) LAWS OF ANY STATE. THESE SECURITIES MAY NOT BE SOLD, TRANSFERRED, PLEDGED, OR HYPOTHECATED UNLESS THEY HAVE FIRST BEEN REGISTERED UNDER THE SECURITIES ACT OF 1933 AND UNDER THE APPLICABLE STATE SECURITIES (“BLUE SKY”) LAWS OR UNLESS THE AVAILABILITY OF AN EXEMPTION FROM REGISTRATION UNDER SUCH ACT AND LAWS IS ESTABLISHED TO THE SATISFACTION OF THE COMPANY, WHICH MAY NECESSITATE A WRITTEN OPINION OF SELLER’S COUNSEL SATISFACTORY TO COMPANY COUNSEL.

(c) The Company shall be obligated to reissue promptly unlegended certificates at the request of any holder thereof if the holder shall have obtained an opinion of counsel (which counsel may be counsel to the Company) reasonably acceptable to the Company to the effect that the securities proposed to be disposed of may lawfully be so disposed of without registration, qualification or legend. The Company shall bear the costs of any such reissuance, including the reasonable legal fees and expenses incurred in connection with the rendering of
the aforementioned legal opinion, provided that legal counsel rendering such opinion is counsel to the Company or, if legal counsel to the Company is unable or unwilling to render such opinion in a reasonable time frame, other counsel reasonably acceptable to the Company (in any case, the Company shall not bear the cost of obtaining legal opinions from such other legal counsel in excess of $3,500 for securities purchased pursuant to this Agreement).

(d) Any legend endorsed on an instrument pursuant to applicable state securities laws and the stop-transfer instructions with respect to such securities shall be removed upon receipt by the Company of an order of the appropriate blue sky authority authorizing such removal.

2.2 Rule 144 Reporting. With a view to making available to the Holders the benefits of certain rules and regulations of the SEC that may permit the sale of the Registrable Securities to the public without registration, the Company agrees to use its best efforts to:

(a) Make and keep public information available, as those terms are understood and defined in SEC Rule 144 or any similar or analogous rule promulgated under the Securities Act, at all times after the effective date of the first registration filed by the Company for an offering of its securities to the general public;

(b) File with the SEC, in a timely manner, all reports and other documents required of the Company under the Exchange Act;

(c) So long as a Holder owns any Registrable Securities, furnish to such Holder forthwith upon request: a written statement by the Company as to its compliance with the reporting requirements of the Exchange Act (at any time after it has become subject to such reporting requirements); a copy of the most recent annual or quarterly report of the Company; and such other reports and documents as a Holder may reasonably request in availing itself of any rule or regulation of the SEC allowing it to sell any such securities without registration.

2.3 Drag-Along Rights.

(a) If the Company’s Board of Directors (the “Board”) and the holders of a majority of the Company’s outstanding capital stock (voting together as one class on an as-converted basis) (the “Majority Holders”) approve a Sale of the Company (an “Approved Sale”) prior to the occurrence of a Qualified Public Offering of common stock of the Company, the Holder shall take all necessary actions in connection with the consummation of the Approved Sale as requested by the Board. The holders of a majority of the shares of common stock of the Company, and the Company (whether directly or through an affiliate, as such term is defined under Rule 12-b-2 of the Exchange Act) shall have the right, but not the obligation, to require the Holders of Shares to sell all of such Shares to such transferee; provided that (A) the consideration to be received by the Holders of Shares shall be the same amount (per share) and type of consideration as that received by the Company and its affiliates (as such term is defined under Rule 12-b-2 of the Exchange Act) and, in any event, shall be cash or freely transferable
marketable securities; (B) the Holders of Shares are given the opportunity, as provided in the then effective Certificate of Incorporation, to convert their Shares to Common Stock if they so desire; (C) if any holders of a class of capital stock are given an option as to the form and amount of consideration to be received, each holder of such class of capital stock shall be given the same option; and, (D) each holder of then currently exercisable rights to acquire shares of a class of common stock shall be given an opportunity to either (i) exercise such rights prior to the consummation of the Approved Sale and participate in such sale as holders of a class of common stock, or (ii) upon the consummation of the Approved Sale, receive in exchange for such rights consideration equal to the amount determined by multiplying (a) the same amount of consideration per share of a class of common stock in connection with the Approved Sale less the exercise price per share of such class of common stock of such right to acquire such class of common stock by (b) the number of shares of such class of common stock represented by such rights.

(b) **Sale of the Company.** "Sale of the Company," as used herein, shall be defined as any transaction or series of transactions pursuant to which any person(s) or entity(ies) in the aggregate acquires (i) capital stock of the Company possessing the voting power to elect a majority of the Company’s Board (whether by merger, consolidation, reorganization, combination, sale or transfer of the Company’s capital stock, shareholder or voting agreement, proxy, power of attorney or otherwise), or (ii) all or substantially all of the Company’s assets determined on a consolidated basis.

(c) **Terms and Conditions.** The obligations of the Holder to participate in an Approved Sale are subject to the satisfaction of the following terms and conditions:

(i) The Company shall give the Holder written notice of a proposed Approved Sale not less than ten days before such Approved Sale is to take place, which written notice (the "Notice of Sale") shall set forth (1) the name and address of the Proposed Purchaser, (2) the aggregate number of Shares to be sold to the Proposed Purchaser, and (3) the terms and conditions of the proposed Approved Sale, including the proposed amount and form of consideration and terms and conditions of payment offered by such Proposed Purchaser; and

(ii) Any Shares purchased from the Holder pursuant to this Agreement shall be purchased at the same price per share and (except as otherwise expressly provided herein) otherwise on the same terms and conditions as the other Shares being sold in the Approved Sale (it being understood and agreed that such terms and conditions do not include the making of any representations and warranties, indemnities or other similar agreements by the Holder other than representations, warranties and indemnities as to such Holder's ownership of the Shares and such Holder's due authority to sell such Shares).

(d) **Consummation of Sale.** The Holders shall take such actions and execute such documents and instruments as shall be reasonably necessary in order to consummate the Approved Sale expeditiously and on the same terms as the Majority Holders, except that the Holders shall not be required to make any
representations or warranties or give any indemnities other than (i) that they are duly empowered and authorized to carry out the proposed transaction, (ii) that they have valid marketable title to the equity securities proposed to be sold and (iii) that there exist no laws, litigation or agreements that would impair the transfer of their Shares. If, at the end of the 180-day period following the date on which the Drag-Along Notice was delivered, the Majority Holders have not completed the Approved Sale, the Holders shall be released from their obligations hereunder with respect to such Approved Sale. At the closing of any Approved Sale under this Section 2.3, the Holders shall deliver certificates representing the Shares to be transferred by them, duly endorsed for transfer with signature guaranteed and with any stock transfer tax stamps affixed, against delivery of the applicable purchase price or merger consideration. All cost and expenses incurred by the Majority Holders in connection with such Approved Sale shall be borne by the Majority Holders.

(c) Exception. Notwithstanding any provision to the contrary, this Section 2.3 shall not apply to any Sale of the Company in which the Holders receive less than $2.55 per share (as adjusted for any stock dividends, combinations, splits, recapitalizations and the like).

SECTION 3. COVENANTS

3.1 Basic Financial Information and Reporting.

(a) Effective March 31, 2003, the Company will maintain true books and records of accounts in which full and correct entries will be made of all its business transactions pursuant to a system of accounting established and administered in accordance with generally accepted accounting principles consistently applied, and will set aside on its books all such proper accruals and reserves as shall be required under generally accepted accounting principles consistently applied.

(b) As soon as practicable after the end of each fiscal year of the Company, and in any event within 90 days thereafter, the Company will furnish each Investor a consolidated balance sheet of the Company, as at the end of such fiscal year, and a consolidated statement of income and a consolidated statement of cash flows of the Company, for such year, all of which shall be prepared in accordance with generally accepted accounting principles consistently applied and setting forth in each case in comparative form the financial statements for the previous fiscal year, all in reasonable detail. Such financial statements shall be accompanied by a report and opinion thereon by independent public accountants of national standing selected by the Company's Board of Directors.

(c) The Company will furnish each Investor, as soon as practicable after the end of the first, second and third quarterly accounting periods in each fiscal year of the Company, and in any event within 45 days thereafter, a consolidated balance sheet of the Company as of the end of each such quarterly period, and a consolidated statement of income and a consolidated statement of cash flows of the Company for such period and for the current fiscal year to date, all of
which shall be prepared in accordance with generally accepted accounting principles and certified by the chief financial officer of the Company (or the chief accounting officer if no chief financial officer is in place), with the exception that no notes need be attached to such statements and year-end accruals and audit adjustments may not have been made.

(d) The Company will furnish each Major Investor (i) at least 30 days prior to the beginning of each fiscal year an operating budget and updated strategic plan as appropriate for such fiscal year; and (ii) periodic reports on the Company’s progress with respect to milestones set forth in the Company’s strategic plan. Each Major Investor shall be entitled to receive a brief written operational status report after the end of each month (beginning in March 2003), and in any event within 30 days thereafter. Such report shall contain only information that a reasonable investor would expect in order to monitor the status of his investment in the Company and in no event shall the Company be required to provide information in the report that it would not reasonably be expected to provide. In addition, each Major Investor will be entitled to participate in a quarterly conference call for the purpose of reviewing the operational progress of the Company. Such quarterly conference call shall not exceed one hour in duration and shall be held on the third Friday following each quarter-end at 2:00 p.m. Eastern Standard Time. In the event a Major Investor is unable to attend at such time, it hereby waives its right to such quarterly conference call.

3.2 Inspection Rights. Each Major Investor shall have the right to visit and inspect any of the properties of the Company or any of its subsidiaries, and to discuss the affairs, finances and accounts of the Company or any of its subsidiaries with its officers, and to review such books and records as is reasonably requested all at such reasonable times and as often as may be reasonably requested; provided, however, that the Company shall not be obligated under this Section 3.2 with respect to a competitor of the Company or with respect to information which the Board of Directors determines in good faith is confidential and should not therefore be disclosed.

3.3 Confidentiality of Records. Each Investor agrees to use, and to use its commercially reasonable efforts to insure that its authorized representatives use, the same degree of care as such Investor uses to protect its own confidential information to keep confidential any information furnished to it by the Company (so long as such information is not in the public domain and unless the Company indicates in writing that such information is not confidential), except that such Investor may disclose such proprietary or confidential information to any partner, subsidiary, member or parent of such Investor for the purpose of evaluating its investment in the Company as long as such partner, subsidiary, member or parent is advised of the confidentiality provisions of this Section 3.3.

3.4 Expenses: Compensation. The reasonable travel expenses of each director (or observer) incurred to attend Board or committee meetings shall be reimbursed by the Company. If the Company adopts a program to compensate its “outside” or “independent” directors generally either with cash or with stock options, then it shall also extend the same compensation to the directors who were elected
as representatives of the Series A Stock (unless such representative is also an officer or employee of the Company), and in the case of stock options such options shall be transferable by the individual Board members to their respective firms.

3.5 **Board Composition and Committees.** The Company shall establish audit and compensation committees by December 31, 2003 and the director who is elected as a representative of the Series A Stock shall be entitled to serve on such committees. In the event the Second Closing is completed and so long as __________ holds at least 500,000 shares of Series A Preferred Stock, the representative of the Series A Stock shall be a person designated by ___________ and such person shall serve on the compensation committee and the audit committee.

3.6 **Indemnification.** The Company's Certificate of Incorporation and Bylaws shall provide, to the maximum extent permitted by Delaware law, for elimination of the liability of directors and for indemnification of directors and officers for acts on behalf of the Company.

3.7 **Board of Director Approval.** The Company shall not, without the approval of the Board of Directors, including a majority of the non-employee directors, declare or pay any cash dividend or cash distribution to any holder of the Company's capital stock.

3.8 **Certain Covenants Relating to SBA Matters.**

(a) **Use of Proceeds.** The proceeds from the issuance and sale of the Series A Stock pursuant to the Purchase Agreement (the "Proceeds") shall be used by the Company for its growth, modernization or expansion. Specifically, the proceeds shall be used for working capital and general corporate purposes. The Company shall provide each Investor which is a licensed Small Business Investment Company (an "SBIC Investor") and the Small Business Administration (the "SBA") reasonable access to the Company's books and records for the purpose of confirming the use of Proceeds.

(b) **Business Activity.** For a period of one year following the Initial Closing under the Purchase Agreement the Company shall not change the nature of its business activity if such change would render the Company ineligible as provided in 13 C.F.R. Section 107.720.

(c) **Compliance.** So long as any SBIC Investor holds any securities of the Company, the Company will at all times comply with the non-discrimination requirements of 13 C.F.R. Parts 112,113 and 117.

(d) **Information for SBIC Investor.** Within 45 days after the end of each fiscal year and at such other times as a SBIC Investor may reasonably request, the Company shall deliver to such SBIC Investor a written assessment, in form and substance satisfactory to such SBIC Investor, of the economic impact of such SBIC Investor's financing specifying the full-time equivalent jobs created or retained in connection with such investment, and the impact of the financing on the Company's business in terms of profits and on taxes paid by the Company and its employees. Upon request, the Company agrees to promptly provide each
SBIC Investor with sufficient information to permit such Investor to comply with its obligations under the Small Business Investment Act of 1958, as amended, and the regulations promulgated thereunder and related thereto; provided, however each SBIC Investor agrees that it will protect any information which the Company labels as confidential to the extent permitted by law. Any submission of any financial information under this Section shall include a certificate of the Company’s president, chief executive officer, treasurer or chief financial officer.

3.9 Insurance. The Company will use its best commercial efforts to obtain as soon as practicable, and keep in effect during the term of this Agreement (a) key person insurance in the amount of $2,000,000 on ____________; (b) directors and officers insurance for $1,000,000 of coverage if available at a commercially reasonable cost.

3.10 Intellectual Property Protection: Non-Compete Agreements. The Company will use commercially reasonable efforts following the Closing to consult with its intellectual property counsel to develop a strategy for the protection of its intellectual property rights, including seeking patent, trademark and copyright protection as deemed appropriate by the Company. The Company will have all employees execute and deliver employment, proprietary information and invention assignment agreements at least as favorable to the Company as those delivered by employees in connection with the Closing. The Company will have all officers execute and deliver non-competition agreements substantially in the form delivered by the current officers at the Closing.

3.11 Compensation. The Company will not, without the unanimous approval of the compensation committee, increase the compensation of any officer or director by more than 10% annually or issue stock or grant stock options relating to more than 25,000 shares annually to each such officer or director, regardless of the vesting period applicable to any such issuance or grant.

3.12 Termination of Covenants. All covenants of the Company contained in Section 3, other than Section 3.6, shall expire and terminate as to each Investor on the earlier of (i) the effective date of the registration statement pertaining to the Qualified Public Offering; and (ii) the closing of an Acquisition or Asset Transfer (as such terms are defined in the Company’s Certificate of Designations, Preferences and Rights of Series A Preferred Stock).

SECTION 4. PREEMPTIVE RIGHTS

4.1 Subsequent Offerings. Each Investor shall have a preemptive right to purchase its Pro Rata Share, as defined below, of all Equity Securities, as defined below, that the Company may, from time to time, propose to sell and issue after the date of this Agreement, other than the Equity Securities excluded by Section 4.6 hereof. Each Investor’s Pro Rata Share is equal to the ratio of (A) the number of shares of Registrable Securities which such Investor is deemed to be a holder immediately prior to the issuance of the Equity Securities to (B) the total number of shares of the Company’s Common Stock (including all shares of Common Stock issued or issuable upon conversion of the Shares or upon the exer-
cise of any outstanding options or warrants) outstanding immediately prior to the issuance of the Equity Securities. The term "Equity Securities" shall mean (i) any Common Stock, Preferred Stock or other security of the Company; (ii) any security convertible, with or without consideration, into any Common Stock, Preferred Stock or other security (including any option to purchase such a convertible security); (iii) any security carrying any warrant or right to subscribe to or purchase any Common Stock Preferred Stock or other security; (iv) any such warrant or right; or (v) any option to acquire any security of the Company, unless expressly excluded under Section 4.6.

4.2 Exercise of Rights. If the Company proposes to issue any Equity Securities it shall give each Investor written notice of its intention, describing the Equity Securities, the price and the terms and conditions upon which the Company proposes to issue the same. Each Investor shall have ten business days from the giving of such notice to agree to purchase its Pro Rata Share of the Equity Securities for the price and upon the terms and conditions specified in the notice by giving written notice to the Company and stating therein the quantity of Equity Securities to be purchased. Notwithstanding the foregoing, the Company shall not be required to offer or sell such Equity Securities to any Investor who would cause the Company to be in violation of applicable federal securities laws by virtue of such offer or sale.

4.3 Issuance of Equity Securities to Other Persons. If not all of the Investors elect to purchase their Pro Rata Share of the Equity Securities, then the Company shall promptly notify in writing the Investors who do so elect and shall offer such Investors the right to acquire such unsubscribed shares. The Investors shall have five business days after receipt of such notice to notify the Company of its election to purchase all or a portion thereof of the unsubscribed shares. If the Investors fail to exercise in full their respective preemptive rights, the Company shall have 90 days thereafter to sell the Equity Securities in respect of which the Investors' rights were not exercised, at a price and upon general terms and conditions materially no more favorable to the purchasers thereof than specified in the Company's notice to the Investors pursuant to Section 4.2 hereof. If the Company has not sold such Equity Securities within 90 days of the notice provided pursuant to Section 4.2, the Company shall not thereafter issue or sell any Equity Securities, without first offering such securities to the Investors in the manner provided above. If any of the Investors do not elect to purchase securities pursuant to this Section 4, they shall not be entitled to an anti-dilution adjustment as provided in the Certificate of Incorporation for the respective issuance of those Equity Securities for which the Investor did not participate.

4.4 Termination of Preemptive Rights. The preemptive rights established by this Section 4 shall not apply to, and shall terminate upon the completion of the Company's Qualified Public Offering. The preemptive rights of first refusal established by this Section 4 may be amended, or any provision waived, on behalf of all Investors with the written consent of Investors holding a majority in interest of the Registrable Securities held by all Investors, provided that the rights of any Investor may not be waived except by such Investor for any securi-
ties issued, or committed to be issued, prior to the earlier of the (a) the Second Closing (as defined in the Purchase Agreement); or (b) October 31, 2000.

4.5 **Transfer of Preemptive Rights.** The preemptive rights of each Investor under this Section 4 may be transferred to the same parties, subject to the same restrictions, as any transfer of registration rights.

4.6 **Excluded Securities.** The preemptive rights established by this Section 4 shall have no application to any of the following Equity Securities:

(a) up to an aggregate of 2,125,000 shares of Common Stock (and/or options, warrants or other Common Stock purchase rights issued pursuant to such options, warrants or other rights) issued or to be issued to employees, officers or directors of, or consultants or advisors to the Company or any subsidiary, pursuant to stock purchase or stock option plans or other arrangements that are approved by the Board of Directors, including existing options outstanding at the date hereof;

(b) 3,661,432 shares of Common Stock previously issued;

(c) any Equity Securities issued for consideration other than cash pursuant to a merger, consolidation, acquisition or similar business combination that (a) is with an entity in which no shareholder of the Company has a direct or indirect beneficial ownership (or the right to acquire such ownership) of more than 1% and (b) that has been approved by the Board of Directors and holders of a majority of the then outstanding Registrable Securities;

(d) shares of Common Stock issued in connection with any stock split, stock dividend or recapitalization by the Company, provided such action is pro-rata among all shareholders of all classes of stock;

(e) up to an aggregate of 100,000 shares of Equity Securities issued pursuant to any equipment leasing arrangement, or debt financing from a bank or similar financial institution that has been approved by the Board of Directors (including the representative of the Series A Stock);

(f) the Shares issued pursuant to the Purchase Agreement;

(g) shares of Common Stock issued upon conversion of the Shares; and

(h) any Equity Securities that are issued by the Company pursuant to a registration statement filed under the Securities Act.

**SECTION 5. MISCELLANEOUS**

5.1 **Governing Law.** This Agreement shall be governed by and construed under the laws of the State of __________.

5.2 **Survival.** The representations, warranties, covenants, and agreements made herein shall survive any investigation made by any Holder and the
5.3 **Sunset Provision.** Upon the consummation of the first Qualified Public Offering, as such term is defined in this Agreement, the preemptive rights, transfer restrictions and information rights, as described in this Agreement and the Restated Certificate of Incorporation of the Company shall expire automatically, except as to Section 3.6 with respect to any officer or director affiliated with any Investor.

5.4 **Successors and Assigns.** Except as otherwise expressly provided herein, the provisions hereof shall inure to the benefit of, and be binding upon, the successors, assigns, heirs, executors, and administrators of the parties hereto and, subject to Section 2.1, shall inure to the benefit of and be enforceable by each person who shall be a holder of Registrable Securities from time to time; provided, however, that prior to the receipt by the Company of adequate written notice of the transfer of any Registrable Securities specifying the full name and address of the transferee, the Company may deem and treat the person listed as the holder of such shares in its records as the absolute owner and holder of such shares for all purposes, including the payment of dividends or any redemption price.

5.5 **Severability.** In case any provision of the Agreement 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.

5.6 **Amendment and Waiver.**

(a) Except as otherwise expressly provided, this Agreement may be amended or modified only upon the written consent of the Company and the holders of a majority in interest of the Registrable Securities.

(b) Except as otherwise expressly provided, the obligations of the Company and the rights of the Holders under this Agreement may be waived only with the written consent of the holders of at least a majority in interest of the Registrable Securities.

(c) Notwithstanding the foregoing subsections (a) and (b), no amendment or waiver of any of the provisions of this Agreement shall be effective against any Investor without the consent of that Investor for any action taking place prior to the earlier of (a) the Second Closing or (b) October 31, 2000.

5.7 **Delays or Omissions.** It is agreed that no delay or omission to exercise any right, power, or remedy accruing to any Holder upon any breach, default or noncompliance of the Company under this Agreement shall impair any such right, power, or remedy, nor shall it be construed to be a waiver of any such breach, default or noncompliance, or any acquiescence therein, or of any similar breach, default or noncompliance thereafter occurring. It is further agreed that
any waiver, permit, consent, or approval of any kind or character on any Holder's part of any breach, default or noncompliance under the Agreement or any waiver on such Holder's part of any provisions or conditions of this Agreement must be in writing and shall be effective only to the extent specifically set forth in such writing. All remedies, either under this Agreement, by law, or otherwise afforded to Holders shall be cumulative and not alternative.

5.8 Notices. All notices required or permitted hereunder shall be in writing and shall be deemed effectively given: (i) upon personal delivery to the party to be notified, (ii) when sent by confirmed telex or facsimile if sent during normal business hours of the recipient; if not, then on the next business day, (iii) three business days after having been sent by registered or certified mail, return receipt requested, postage prepaid, or (iv) one day after deposit with a nationally recognized overnight courier, specifying next day delivery. All communications shall be sent to the party to be notified at the address as set forth on the signature pages of the Purchase Agreement at such other address as such party may designate by ten days advance written notice to the other parties hereto.

5.9 Entire Agreement. This Agreement, the exhibits and schedules hereunto, the Purchase Agreement and the other documents delivered pursuant thereto constitute the full and entire understanding and agreement between the parties with regard to the subjects hereof.

5.10 Attorneys' Fees. In the event that any dispute among the parties to this Agreement should result in litigation, the prevailing party in such dispute shall be entitled to recover from the losing party all fees, costs and expenses of enforcing any right of such prevailing party under or with respect to this Agreement, including without limitation, such reasonable fees and expenses of attorneys and accountants, which shall include, without limitation, all fees, costs and expenses of appeals.

5.11 Titles and Subtitles. The titles of the sections and subsections of this Agreement are for convenience of reference only and are not to be considered in construing this Agreement.

5.12 Counterparts. This Agreement may be delivered via facsimile and executed in any number of counterparts, each of which shall be an original, but all of which together shall constitute one instrument.

IN WITNESS WHEREOF, the parties hereto have executed this Investors' Rights Agreement as of the date set forth in the first paragraph hereof.

THE COMPANY

By: ____________________________

INVESTORS

By: ____________________________
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