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Columbia Venture Partners - MedTech Inc.

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## **Columbia Venture Partners – MedTech Inc.**

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### Abstract:

This case study is a teaching exercise that was first used in the “Deals Workshop” seminar at Columbia Law School in April 2003. The case involves a potential investment by Columbia Venture Partners, a venture capital fund, in MedTech Inc., an emerging developer of medical devices for the cardiovascular market. The case offers an opportunity to examine the relative importance of various terms in typical venture capital contracts, such as valuation, liquidation preference, conversion rights, board representation, tag-along and drag-along rights, and vesting. The case also illustrates the use of negotiation tactics, including the use of “market” or industry standards, efficient risk allocation, and how to bring other objective criteria into the discussion.

The case includes a teacher’s manual followed by a background memo and term sheet intended for distribution to the students.

Columbia Venture Partners – Medtech  
Term Sheet Negotiation Exercise

Teacher's Manual

This case study concerns a potential investment by Columbia Venture Partners II, LLP, a venture capital fund, in MedTech Incorporated, an emerging developer of medical devices for the cardiovascular market.

**I. In-Class Demonstration Exercise vs. Outside-of-Class Simulation**

The case is suitable for use as either an outside-of-class student simulation exercise or as an in-class demonstration exercise. I found the case especially effective as we used it – as a demonstration exercise sandwiched between outside-of-class student exercises on related materials.

Rather than have the students represent the principals in a simulated negotiation, Geoffrey Smith and one of his colleagues, Lawrence Atinsky, each represented a principal in the transaction. For our class, Geoffrey played the part of Counsel to MedTech, and Lawrence played the part of Counsel to the VC Fund. Comments from students suggest that this format, by providing a peek into the usual tactics of experienced negotiators, was most helpful in solidifying their understanding of concepts we had discussed previously in class.

A bit more background might be useful. The Deals Workshop takes students through a series of negotiation and drafting exercises, starting with a venture capital case study, followed by a music industry recording contract exercise, a book contract exercise, an employment agreement exercise, and finishing with a venture capital term sheet negotiation and drafting exercise. Early in the course I lead a discussion of negotiation theory, drawing mainly on Fisher & Ury's *Getting to Yes* and Robert Mnookin's *Beyond Winning*. I used this case study towards the end of the course, after the students already had their feet wet and were familiar with both some negotiation theory and had some practical, if simulated, negotiation experience. The case worked particularly well because the subject matter of the negotiations paralleled the issues in the venture capital negotiation that the students were conducting outside of class.

The in-class demonstration was also useful because it is otherwise hard to teach how negotiation tactics are used in the real world. I do sometimes engage in "role playing" exercises in class where I negotiate with a student, but students often have trouble staying "in character," instead falling back into the more comfortable student-teacher dynamic and following my lead. Having student-student demonstration exercises can sometimes be productive as well, but I find it hard to prompt students to use new tactics.

Using experienced negotiators as the principals in the exercise thus gave the students helpful, salient demonstrations of negotiation tactics that had been previously

discussed in class. Geoffrey has conducted similar demonstrations for the Biotech Association meeting and at Morrison & Foerster, a New York law firm. Press coverage of those demonstrations is available at

<http://www.nytimes.com/2002/09/30/technology/30VENT.html> and <http://online.wsj.com/article/0,,SB1033584005290022793,00.html>.

## II. Setting the Stage

The background memo provides the context for the negotiation. It is important that the students understand that MedTech is an early stage company with very few, if any, alternative sources of funding.

The “market” standard for venture capital terms has changed substantially since 2000. The internet has a fair amount of information about what sorts of deals people are getting; one place to look is:

<http://www.kelleydrye.com/resourcecenter/Venture%20Capital/Trends%20In%20Venture%20Capital%20Financing%20Terms.pdf>

Understanding MedTech’s business is not absolutely critical to the case, as the case focuses on issues that are common to all early-stage venture deals. Nevertheless, the negotiators will naturally refer to specific information about the company when discussing the terms of the investment. Thus, when introducing the case it may be useful to talk a bit about MedTech’s two products. The first product has reached the end of the FDA regulatory process but has not yet been approved for commercial sale; thus, final FDA approval may be an important milestone. One way to think about the FDA process is to say that in addition to the usual technology risk and product market risk, there is a “regulatory risk” – i.e., the risk that FDA final approval will not be as easy as anticipated. The second product is even earlier in the FDA process.

It is also important that the students understand the basic mechanics of a venture capital investment. I introduce these concepts earlier in the course, but it might also be possible to do so in a brief introduction to the case. Some key concepts include:

- *Variability of VC investments.* Regardless of the talent level of the entrepreneurs and investors involved, many more portfolio companies fail than succeed, and only a handful achieve huge success. For every 10 portfolio companies that a VC fund invests in, perhaps 6 will fail completely, 3 will achieve moderate success, and one will be a “home run.” VC funds achieve most of their returns from the home runs, yet many of the terms in the term sheet come into play only in the middle ground of “zombies” or moderately successful companies. **One lesson I try to convey, then, is that issues that can directly affect the success or failure of the company, like board representation, are likely to matter more to the principals than issues that affect the division of proceeds at the margin, like the cap on a liquidation preference.**

- *Participating Preferred Stock.* VCs typically receive participating preferred stock in exchange for their investments. In addition to the liquidation preference, the participation feature allows the VCs to convert their stock into common and share the upside with the common. Numerical examples can help demonstrate how this can motivate founders to work for the “home run,” as the VCs will receive most of the proceeds for exits with middling returns.
- *Liquidation Preference.* VCs now often receive a 2x or 3x multiple on their investment before the common receives anything; this is achieved through the operation of the liquidation preference on the preferred stock. In the event of a successful exit, the VCs take the liquidation preference off the top and then convert into common to share in the remaining proceeds. The liquidation preference is often capped at a certain amount; if the proceeds would exceed this amount, the preferred simply converts into common and shares pro rata.

I discuss some other important concepts below in the context in which they may arise in the exercise.

### **III. The In-Class Exercise**

The students should have the term sheet in front of them so they can follow along. The two negotiators (Counsel to VC and Counsel to Company) should, whenever possible, proceed through the term sheet in order; although this would not always happen in practice, it does make it easier for the students to follow.

The following section discusses issues that the negotiators might wish to cover. It’s probably impossible to cover everything, or indeed to reach agreement on very many issues within the artificial constraint of a two hour seminar. But I think it is more important to demonstrate the dynamics of the discussion rather than to artificially force agreement on an issue that would not be resolved so quickly in practice.

After each issue, the negotiators should pause, drop out of character, and field questions from the students.

#### Valuation (term sheet page 1)

The term sheet contemplates that the \$6.5 million valuation is inclusive of the 15% option pool. The Company will take the opposite position, arguing that it is unfair to further dilute the Founders. The Company may argue that the Investors knew that additional employees were already contemplated before the investment, that the Company assumed that the Investors took this into account in valuation, and that the options, by attracting talented employees, benefit the Investors as much as the Company.

The parties may also address to what extent the Founders will participate in the option pool.

#### Liquidation Preference (term sheet page 2)

The Company will argue against the 3x liquidation preference. The Investor will argue that the high liquidation preference is appropriate given the high level of uncertainty surrounding the viability of the Company's two products.

If the Investor does not come down from 3x, the Company may suggest milestones (e.g. FDA approval) to reduce the multiple to 1 – 1.5x.

The Company will demand a cap (e.g. 5x) on the Series B's participation rights on liquidation.

The Founders will ask for participation rights on Series A; the Investor may agree to 1x participation rights, but no additional dividend rights for the Series A.

The Investor will object to the inclusion of an IPO in the definition of Liquidation Event; the Investor seeks to receive preference and participation upon IPO (and not just mandatory conversion to common). If the Investor has already agreed to a cap, it may argue that any IPO should have a sufficiently high valuation to make this provision irrelevant.

#### Conversion Rights (term sheet page 3)

The Company will argue to remove accrued dividends out of the conversion formula. The Investor may argue that accrual is necessary to incentivize the Founders to move quickly.

#### Antidilution (term sheet page 3)

The Company will ask for weighted-average anti-dilution, instead of full-ratchet. The provision becomes important in the event of a downround financing, and the Investor will argue that it is essential that the Investor be protected in the event that the Company does poorly. The Company will respond that market downturns can affect all companies, even good ones; that full-ratchet protection is unnecessarily punitive; and that it would make it extremely difficult to achieve additional financing from another source, should the need arise.

#### Board Representation (term sheet page 4)

The Company will request that both Founders receive board seats, arguing that both Founders have been equally committed to and invested in the Company to this point.

### Rights of First Offer (term sheet page 7)

The Founders will object to the Investor's right to purchase 100% of subsequent rounds of financing. The Company will argue that this exposes the Company to the risk of a hold up by the Investors, as any new investors will be wary of making an offer subject to these rights. The Investors will argue that the right of first offer is a necessary protection of the current investment.

Possible compromise: the Investor will receive the right only to maintain its pro rata share ownership of the Company.

The Founders may request preemptive rights to participate in future financings.

### Share Vesting (term sheet page 8)

The Founders will argue that it is not appropriate to have reverse vesting. The Founders currently are vested, and the Investors may wish to make their stock subject to new vesting requirements so as to assure continued commitment to the Company going forward.

The Investor may offer that the Founders may receive accelerated vesting if they are terminated by the Company, and will be subject to a buy-back if they are terminated for cause or voluntarily resign.

The Company will request acceleration of vesting on a change of control (not including an IPO).

### Exclusive Dealing (term sheet page 9)

The Investor's initial proposal is 60 day no-shop. The Company will counter with 30 days, and the parties may settle on 45 days. (Note: 45 days is the proposed closing date set forth on the first page.) A long exclusive dealing period may be problematic for the Company if the deal falls through and the Company is already short on cash.

## Background: Venture Capital Term Sheet Negotiation

### The Setting

The present. A conference room of a leading corporate law firm in New York City.

### The Participants

The Company	MedTech Incorporated (“MedTechCo”), an emerging developer of medical devices for the cardiovascular market.
The Investor	Columbia Venture Partners II, LLP (“CVP”), a \$250 million venture capital fund, focusing primarily on second round (and later) investments in the IT and healthcare sectors.
The Founder	A co-founder and the President of the Company.
The Venture Capitalist	A managing general partner of the Investor.
Attorney A	Counsel to the Company.
Attorney B	Counsel to the Investor.

### Background

MedTechCo was founded in 2001 by The Founder and his co-founder, who serves as the Chief Medical Officer. Together, the founders currently own all of MedTechCo’s common stock. MedTechCo’s initial seed financing was provided by the founders. Friends and family subsequently invested **\$1.0 million to purchase Series A Preferred Stock in 2001**. The proceeds from the Series A round have been used in connection with the Company’s product development efforts.

MedTechCo was originally founded to develop a device to allow for “clampless” coronary artery bypass grafts. The initial product has reached the end of the FDA regulatory process but has not yet been approved for commercial sale. The Company has been working to develop a second product line for minimally invasive coronary artery bypass grafts. **The initial animal data on the new product is encouraging, but the Company faces a lengthy FDA approval process before this product can be sold commercially.** MedTechCo’s projections indicate that its initial product will be available for commercial sale **in six months and that the second product will hit in the market in two years.** MedTechCo currently has **15 employees**, and after the closing of this round of financing, plans to increase its staff substantially in order to focus on the new product line.

CVP has a strong investment record over its eight years of existence. Several of its portfolio companies have completed initial public offerings, or have been acquired by

industry leaders, at prices reflecting a substantial profit for the fund. However, a number of the fund's portfolio companies have failed during the past two years and a number of others are currently on the ropes. Several of the fund's limited partners are a bit squeamish about current market conditions. Accordingly, fund management is under considerable pressure to be quite choosy in selecting new investments, and to stick to deal terms that will help CVP to protect itself if a portfolio company's performance is not to plan.

MedTechCo and CVP have been discussing a possible investment for approximately six weeks, and fund management has completed a large portion of its business and technical due diligence. In their last meeting, the parties agreed that:

- CVP (possibly with other fund investors) will invest \$5.0 million in new Series shares;
- The pre-money valuation of the Company will be \$6.5 million;
- The fund's counsel would prepare a term sheet for the proposed investment; and
- MedTechCo, CVP and their respective counsel would meet today to negotiate the term sheet.

**MEMORANDUM OF TERMS  
FOR  
PRIVATE PLACEMENT  
OF  
SERIES B PREFERRED STOCK  
OF  
MEDTECH INCORPORATED**

**APRIL 14, 2003**

The intent of this document is to describe certain key terms of the proposed agreements between Columbia Venture Partners II, LLP (the "Investor") and MedTech Incorporated, a Delaware corporation (the "Company").

This document is for discussion purposes only and is not intended to be a binding agreement between the Investor and the Company with respect to the subject matter hereof, except for the paragraph below captioned "Confidentiality and except for the paragraph below captioned "Exclusive Dealing". A binding agreement will not occur unless and until all necessary Investor and Company approvals have been obtained and the parties have negotiated, approved, executed and delivered the appropriate definitive agreements. Until execution and delivery of such definitive agreements, both parties shall have the absolute right to terminate all negotiations for any reason without liability therefor.

<b>Pre-Money Valuation:</b>	\$6.5 million
<b>Amount of Financing:</b>	\$5.0 million from the Investor, representing approximately 44% of the ownership of the Company (after giving effect to the creation of a 15% option pool; see the historical and pro forma capitalization tables attached hereto at Exhibit A).
<b>Security:</b>	Shares of Series B Preferred Stock ("Series B Preferred") at \$3.60 per share (the "Purchase Price").
<b>Anticipated Closing:</b>	On or about June 1, 2003 (approximately 45 days from the date of this document).
<b>Rights, Privileges and Preferences of Series B Preferred Stock:</b>	
<b>Dividend Rights:</b>	The Series B Preferred shall be entitled to an annual per share dividend equal to 10% of the Purchase Price, payable whenever funds are legally available and when, as and if declared by the Board of Directors (the "Board"). The dividends shall be cumulative, and shall be paid prior to payment of any dividend with respect to the Common Stock and any other series of Preferred Stock. After payment of the preferential dividend to the holders of the Series B Preferred and any preferential dividend to the holders of any other series of Preferred Stock, any further dividends shall be paid pro rata to the holders of the Series B Preferred and the Common Stock on an as-converted basis.

**Liquidation Preference:**

In the event of any liquidation, dissolution or winding up of The Company, the holders of the Series B Preferred shall be entitled to receive, prior to any distribution to the holders of the Common Stock and prior to the Series A Preferred Stock, an amount equal to the product of (a) three (3) and (b) the Purchase Price plus all declared but unpaid dividends thereon (the "Preference Amount").

After the full Preference Amount on all outstanding shares of Series B Preferred and any liquidation preference of any other series of Preferred Stock has been paid, any remaining funds and assets of the Company legally available for distribution to shareholders shall be distributed pro rata among the holders of the Common Stock, Series B Preferred and other series of Preferred Stock on an as-converted basis. If the Company has insufficient assets to permit payment of the Preference Amount in full to all Series B Preferred shareholders as provided in this paragraph, then the assets of the Company shall be distributed ratably to the holders of the Series B Preferred in proportion to the Preference Amount each such holder would otherwise be entitled to receive.

A merger or consolidation of the Company in which its shareholders do not retain a majority of the voting power in the surviving corporation, the exclusive licensing of substantially all of the Company's intellectual property, or the sale of all or substantially all the Company's assets, any transaction in which majority control is transferred through a transfer of more than 50% of the stock on an as-converted basis, and an initial public offering of the Company shall each be deemed to be a liquidation, dissolution or winding up of the Company (each a "Liquidation Event").

**Redemption:**

Subject to any legal restrictions on the Company's redemption of shares, beginning on the third anniversary of the Closing, the holders of a majority of the then outstanding Series B Preferred may require the Company to redeem all or a portion of the outstanding Series B Preferred.

The redemption price for each share of Series B Preferred shall be the Purchase Price plus all declared but unpaid dividends thereon to the date of redemption plus an amount equal to 15% of the Purchase Price (the "Redemption Price"). The Redemption Price shall be proportionally adjusted for stock splits, stock dividends, etc. If on the redemption date, the number of shares of Series B Preferred that may then be legally redeemed by the Company is less than the number of such shares requested to be redeemed, then the shares to be redeemed but that may not be legally redeemed shall be

carried forward and redeemed as soon as the Company has legally available funds therefor.

**Conversion Rights:**

The holders of the Series B Preferred shall have the right to convert their shares of Preferred Stock (giving effect to accrued and unpaid dividends on the Series B Preferred) into shares of Common Stock at any time. The total number of shares of Common Stock into which the Series B Preferred may be converted initially will be determined by dividing the Purchase Price by the conversion price. The initial conversion price will be the Purchase Price (i.e., a 1-to-1 initial conversion ratio). The conversion price will be subject to adjustment to reflect dividends, stock splits and similar events and as provided in “Antidilution Provisions” below.

**Automatic Conversion:**

The Series B Preferred shall automatically be converted Into Common Stock, at the then applicable conversion rate, (i) immediately prior to the closing of, and conditioned upon the closing of, the first underwritten public offering of shares of Common Stock of the Company at a public offering price of at least five times the Purchase Price per share and gross proceeds to the Company in excess of \$35 million (the “Qualified Public Offering”), or (ii) on the date specified by the holders of at least two-thirds of the then outstanding shares of Series B Preferred Stock.

**Antidilution Provisions:**

The conversion price of the Series B Preferred shall be subject to adjustment on a full-ratchet basis for issuances at a purchase price less than the then-effective conversion price (and accrued but unpaid dividends) with carve-outs for issuances of Common Stock in an amount equal to 15% of the Company’s capital stock as of the closing date, which shall be reserved for issuance to employees, officers or directors pursuant to stock purchase or stock option plans or agreements or other incentive stock arrangements approved by the stockholders and the Board (the “Incentive Pool”); issuances in connection with public offerings pursuant to which all outstanding Preferred Stock is automatically converted; issuances in connection with the exercise or conversion of exercisable or convertible securities that are outstanding as of the closing or that are subsequently issued in a manner permitted by this paragraph; all subject to standard limitations. Proportional adjustments shall be made to the conversion price for stock splits, stock dividends and other recapitalizations.

**Voting Rights:**

Each share of Series B Preferred shall carry the number of votes equal to the number of shares of Common Stock then

issuable upon its conversion into Common Stock. The Series B Preferred shall generally vote together with the Common Stock and not as a separate series or class, except as provided by law or as provided in “Board Representation” or “Protective Provisions” below.

**Board Representation:**

The size of the Board of Directors of the Company will be fixed at five. So long as any of the Series B Preferred issued in this financing remain outstanding, the Series B Preferred (voting separately as a series) will elect two directors, the Series A Preferred (voting separately as a series) will elect one director, and the holders of Common Stock (voting as a class) will elect one director. The fifth director will be nominated by the founders, of the Company (the “Founders”), and approved by a majority of the four other members of the Board of Directors. No more than one member of the Board of Directors may be an officer or key employee of the Company.

**Protective Provisions:**

Consent of the holders of a majority of the outstanding Series B Preferred, voting separately as a separate series, shall be required for: (i) any amendment or change of the rights, preferences, privileges or powers of, or the restrictions that provide for the benefit of, the Series B Preferred that adversely affects such shares; (ii) any increase or decrease in the number of authorized shares of the Series B Preferred; (iii) any action that authorizes, creates or issues shares of any class of stock having preferences superior to or on parity with the Series B Preferred; (iv) any action that reclassifies any outstanding shares of Series B Preferred; (v) any merger or consolidation of the Company or any subsidiary; (vi) any increase in the number of directors beyond the number set forth herein; (vii) the declaration or payment of a dividend on the capital stock of the Company; (viii) the redemption or repurchase of capital stock (subject to certain limited exceptions); (ix) any incurrence of indebtedness in excess of \$50,000; or (x) any other material changes in or deviations from the Company’s business plan.

**Terms of the Stock  
Purchase Agreement:**

The purchase of shares of Series B Preferred shall be made pursuant to a Stock Purchase Agreement approved by the Company and the Investor, which agreement shall contain, among other things, customary representations and warranties of the Company and the Investor, covenants of the Company reflecting the provisions set forth herein, and appropriate conditions of closing, including an opinion of counsel for the Company. In such Agreement, the Founders shall, jointly with the Company, make representations and warranties regarding the Company’s intellectual property.

- Use of Proceeds:** The proceeds from the sale of the Series B Preferred will be used for research and development, sales and marketing and working capital.
- Confidentiality:** The terms and conditions of the financing, including its existence, shall be confidential information and shall not be disclosed to any third party by the Company except with the Investor's prior written approval.
- Except as required by applicable law, the Investor shall not be identified as a shareholder of the Company without the Investor's prior written consent.
- Confidential Information and Inventions Assignment Agreement:** Each Founder, key officer and key employee of the Company shall have entered into a confidential information and invention assignment agreement satisfactory to the Investor and its counsel. The Company shall use its best efforts to have the remainder of the employees and officers sign such an agreement.
- Terms of Investors' Rights Agreement:** The Company, the Founders, the holders of the Company's Series A Preferred Stock (the "Series A Investors") and the Investor shall enter into an Investors' Rights Agreement which shall contain, among other things, registration rights, information rights and a right of first offer.
- Registration Rights:**
- 1. Demand, S-3 and Piggyback Rights:** The holders of Series B Preferred shall have the following registration rights: (i) two demand registrations upon the request of the holders of a majority of the Series B Preferred; (ii) unlimited registrations on Form S-3; (iii) unlimited piggyback registrations in connection with registrations of shares for the account of the Company or other selling shareholders; and (iv) cut-back provisions providing that registrations must include at least 33% of the shares requested to be included by the holders of Series B Preferred (except a full cut-back shall be permitted upon a Qualified Public Offering) and employees, officers and directors and all other holders of the Company's securities must be cut back fully before the holders of Series B Preferred shall be cut back. Demand registration rights shall be exercisable upon the earlier of three years from the Closing or six months after the Company's initial public offering.
  - 2. Expenses:** The Company shall bear the registration expenses (excluding underwriting discounts and commissions but including all other expenses related to the registration, including the legal fees and expenses of

one counsel for the holders of the Series B Preferred) of all registrations.

3. Transfer of Rights: The registration rights may be transferred to a transferee who acquires at least 25% of the shares of Series B Preferred (or Common Stock issued upon conversion thereof). Transfer of registration rights to an affiliate, a shareholder, member, or limited or general partner of the Investor will be without restriction as to minimum shareholding.

4. Termination: The registration rights shall not apply to any holder who can sell all of such holder's shares in any three-month period without registration pursuant to Rule 144(k) promulgated under the Securities Act of 1933.

5. Lock-up: The Investor will agree to a lock-up, not to exceed 180 days, in the event of the initial public offering of the Company, in each case only so long as all officers and directors and 1% shareholders are similarly lockedup.

6. Subsequent Registration Rights: The Company shall not grant registration rights to any existing or future holder of the Company's securities without the prior approval of a majority of the Series B Preferred.

**Information Rights:**

So long as any shares of Series B Preferred are outstanding, the Company shall deliver to each holder of Series B Preferred (i) audited annual financial statements within 90 days after the end of each fiscal year; (ii) unaudited quarterly financial statements within 45 days after the end of each fiscal quarter; (iii) unaudited monthly financial statements within 30 days after the end of each month; and (iv) an annual budget within 30 days prior to the start of each fiscal year. For so long as any shares of Series B Preferred are outstanding, such holders shall have standard inspection rights. These information and inspection rights shall terminate upon a Qualified Public Offering.

**Rights of First Offer:**

Each holder of Series B Preferred shall have a right of first offer to purchase up to 100% of any offering of equity securities made by the Company (other than in a transaction registered under the Securities Act of 1933), on the same price and terms and conditions as the Company offers such securities to other potential investors. This right shall not apply to the issuance by the Company of shares of Common Stock (or securities convertible into or exercisable for shares of Common Stock) issued upon conversion of Preferred Stock or from the Incentive Pool.

**Terms of Right of First Refusal and Co-Sale Agreement:**

The Company, the Founders, the Series A Investors and the Investor shall enter into a Right of First Refusal and Co-Sale Agreement which shall contain, among other things, right of first refusal and co-sale rights which shall give the holders of the Series B Preferred first refusal rights and co-sale rights providing that any Founder or Series A Investor who proposes to sell all or a portion of his or her shares to a third party must permit the holders of the Series B Preferred, at their option, (i) to purchase such holder's pro rata share of such stock on the same terms as the proposed transferee (with a right of oversubscription if any holder of this right of first refusal elects not to purchase its pro rata share), or (ii) sell a proportionate part of their shares on the same terms offered by the proposed transferee. This right shall terminate upon the closing of the Company's Qualified Public Offering, and shall not apply to certain transfers made by the Founders to certain family members or trusts.

**Terms of Voting Agreement:**

The Company, the Founders, the Series A Investors and the Investor shall enter into a Voting Agreement which shall provide, among other things, that all parties thereto will vote or give their written consent with respect to all of their shares so as to achieve the Board of Directors composition set forth in "Board Representation" above.

**Vesting:**

Prior to the Closing, the Founders shall execute Stock Restriction and Vesting Agreements with the Company covering the shares of Common Stock held by the Founders at the Closing, pursuant to which the Company is granted a right to repurchase unvested shares at cost in the event that a Founder's employment with the Company is terminated. 25% of the shares of Common Stock of each Founder shall be deemed vested on the Closing Date, and the remaining shares shall vest, and such shares shall be released from the Company's repurchase right, based on continued employment by the Company, at the initial rate of 1/48 per month thereafter.

Except as otherwise unanimously approved by the Board of Directors, all issuances of Common Stock or grants of options to purchase Common Stock to employees of or consultants to the Company shall be subject to a vesting schedule of four years with 25% vesting upon the first anniversary of commencement of employment or consulting relationship and 1/48 vesting monthly thereafter, and shall provide the Company with a right to repurchase unvested shares

at cost in the event that a shareholder's employment or consulting relationship with the Company is terminated.

**Exclusive Dealing:**

The Company agrees, for the 60 day period commencing as of the date first set forth above, not to enter into discussions with any third party (other than those approved by the Investor in advance) regarding the sale by the Company of any equity securities, other than sales the primary purpose of which is other than to raise capital. The Company agrees to negotiate in good faith with the Investor during such period to enter into the definitive agreements contemplated hereby.

**Conditions of Closing:**

The closing for the purchase of the Series B Preferred will be conditioned upon:

1. Completion of due diligence to the **satisfaction of the Investor in its sole discretion**;
2. Execution by the Company and the Investor of a definitive Stock Purchase Agreement and related agreements;
3. Compliance by the Company with applicable securities laws;
4. Opinion of counsel to the Company rendered to the Investor in form and substance reasonably satisfactory to the Investor; and
5. Such other conditions as are customary for transactions of this type.

**Legal Fees:**

The Company shall reimburse the Investor for the Investor's Expenses arising in connection with the transactions contemplated by this Memorandum of Terms **up to \$35,000**. In addition, the Investors' Rights Agreement (see below) shall provide that so long as the Investor holds any shares of Series B Preferred, **the Company shall reimburse the Investor for all legal fees incurred by the Investor in the course of reviewing consents and other documents (including, but not limited to, documents relating to subsequent rounds of financing)** that the Company requests the Investor to execute after the consummation of the transactions contemplated hereby.

## Exhibit A

## MedTech Incorporated

## Capitalization Tables

Table 1: Actual Capitalization - December 1, 2001 (incorporation)

<u>Holder</u>	<u>Common Stock</u>	<u>% Fully Diluted</u>
Founders	1,000,000	100%
<b>Total</b>	<b>1,000,000</b>	<b>100%</b>

Table 2: Actual Capitalization - February 1, 2002 (Series A closing)

<u>Holder</u>	<u>Common Stock</u>	<u>Series A Preferred Stock</u>	<u>Total Shares</u>	<u>% Fully Diluted</u>
Founders	1,000,000	0	1,000,000	76.93%
Series A Investors	0	300,000	300,000	23.07%
<b>Total</b>	<b>1,000,000</b>	<b>300,000</b>	<b>1,300,000</b>	<b>100%</b>

Table 3: Pro Forma Capitalization - June 1, 2003 (Series B Closing and option pool)

<u>Holder</u>	<u>Common Stock</u>	<u>Series A Preferred Stock</u>	<u>Series B Preferred Stock</u>	<u>Option Pool</u>	<u>Total Outstanding Shares</u>	<u>% Total Outstanding Shares</u>	<u>Total Shares-Fully Diluted</u>	<u>% Fully Diluted</u>
Founders	1,000,000	0	0	0	1,000,000	37.17%	1,000,000	31.62%
Series A Investors	0	300,000	0	0	300,000	11.15%	300,000	9.48%
Series B Investors	0	0	1,390,000	0	1,390,000	51.67%	1,390,000	43.95%
Optionees	0	0	0	472,914	0	0%	472,914	14.95%
<b>Total</b>	<b>1,000,000</b>	<b>300,000</b>	<b>1,390,000</b>	<b>472,914</b>	<b>2,690,000</b>	<b>100%</b>	<b>3,162,914</b>	<b>100%</b>