

What's Happening in Michigan Early-Stage Venture Capital Markets

By Timothy R. Damschroder

Introduction

In the broadest sense, venture capital transactions include a wide variety of corporate finance arrangements. This article discusses the state of fund-raising markets in Michigan for business start-ups and early-stage companies.¹ While a large number of such enterprises are based on information technology,² the financing arrangements discussed in this article apply across the board to all types of business endeavors. This article focuses on the scope and nature of the start-up and early-stage Michigan capital markets, including the typical terms under which transactions are financed, segregated into four distinguishing types: (1) funding sourced from a venture capital fund, (2) funding sourced from one or more angel investors, (3) equity-based transactions, and (4) debt-based transactions. These four different approaches are often intertwined over the life of the enterprise or, at times, combined into the same financing transaction or series of transactions.

Venture capital funds, are, for the most part, limited partnerships (some funds have begun using limited liability companies) managed by a general partner experienced in the venture capital industry and owned by one or more limited partner investors. Angel investors are simply individuals with an appetite for investment in start-up and early-stage companies.

Equity-based transactions involve the sale and purchase of common or preferred stock of the issuing entity. Debt-based transactions generally consist of a secured loan with a warrant to purchase shares in the debtor.

The venture capital industry is full of colloquialisms such as *full ratchet*, *archangel*, *down round*, *follow-on investment*, *clawback*, and *premoney* and *postmoney* valuations. A few of these terms are identified and described in this article.³

Venture Capital Funds

Venture capital funds are limited partnerships or limited liability companies that have been established by one or more persons with some level of experience in the venture capi-

tal industry. The governing documents for the fund usually limit the type of portfolio companies into which the fund may invest to those in specified industries or, at times, a specified group of companies. A venture capitalist may also work with a group of investors in setting up a series of special purpose funds with the sole purpose of investing into one stated company. Accordingly, behind the operating name of each venture capital fund usually lie a series of limited partnerships or limited liability companies through which the investments are actually made.

Exhibit 1 sets forth a list of Michigan-based venture capital funds. Michigan start-ups and early-stage companies also often receive funding from venture capital funds located outside the state. Exhibit 2 is a list of Michigan-based venture capital funded transactions that were reported during calendar year 2004 and the second calendar quarter of 2005.

Exhibit 3 includes graphs showing total venture capital dollars invested into portfolio companies in the United States and in Michigan by year. These charts show that the total venture capital market in Michigan is fairly small compared to that of the entire United States (especially when analyzed against Michigan's annual gross state product figures).

Participants in Michigan venture capital markets have worked long and hard to increase the state's available venture capital. Several recent efforts have been initiated to assist with this growth. One such effort is the creation of the Venture Michigan Fund in January 2004 by the Michigan Legislature as a nonprofit, tax-exempt organization that will act as a "fund of funds." This means that the Venture Michigan Fund will invest in other venture capital funds that have a substantial presence in Michigan. The hope is to create new funds with a Michigan presence or increase the size of current funds.

The Venture Michigan Fund's stated goal is to promote at least two dollars of investment in Michigan businesses for every one dollar of investment into the fund. On April 18, 2005, the Venture Michigan Fund announced that Credit Suisse First Boston

will act as the manager of the fund. Capital is to be raised for the Venture Michigan Fund by providing tax credits that will guarantee investments made into the fund in case the fund is not able to return the amount invested. So as to not limit their own capital-raising efforts, venture capital funds receiving investments from the Venture Michigan Fund are not required to invest those funds in portfolio companies located in Michigan. However, the Venture Michigan Fund will require each venture fund to use its best efforts to invest in Michigan-based companies.

Angel Investors

As noted above, angel investors are individuals who have a special interest or desire to invest in start-up and early-stage companies. There is a loose network of experienced angel investors in Michigan who will often work together to provide funding for an enterprise. Or an angel investor may be a friend, family member, or business acquaintance who has agreed to put funding into the enterprise. Many angels are experienced in the industry to which the enterprise relates (i.e., automotive executives investing in an automotive supply company, or a successful software entrepreneur looking to participate in other technology-sector opportunities).

A lead angel investor is often called an *archangel* or an *angel aggregator*. The angel aggregator performs the useful functions of identifying prospective early-stage companies, conducting due diligence, creating investor disclosure information (such as a private placement memorandum), bringing additional angel investors to the table, negotiating the terms of the investment, and working with a law firm to prepare the documents for the transaction and to negotiate those documents to a closing.

The terms of angel investments are varied and can consist of anything from simple unsecured debt or issuance of common stock to completing a preferred share issuance containing the same (or at times, even more favorable) terms as those found in a typical venture capital transaction.

Entrepreneurs seeking to obtain angel investment should concentrate their efforts on finding one or two lead investors, ideally experienced in their industry, who have connections to a network of other angel investors. Many angel investors will wait to see if a

well-known angel has signed on to the round before agreeing to make an investment. Once one or more well-known angels have agreed to make an investment, more often than not, the round ends up being fully funded (and perhaps angels are turned away).

One successful Michigan entrepreneur, Dwight Carlson, has devised an innovative form of angel financing working with the Bank of Ann Arbor. Called a Michigan Innovation CD, an enterprise seeking funding will enter into a three-party arrangement with a bank and the investors. Under this arrangement, the bank will sell certificates of deposit (CDs) to the investors and the CDs will be used as collateral for a loan by the bank to the enterprise. The company pays interest only on the loan during the term of the loan (suggested to be five years). The investors receive:

- typical quarterly interest payments on the CDs from the bank over the life of the CDs,
- quarterly interest payments directly from the enterprise, and
- a warrant to purchase shares of the enterprise exercisable anytime up to termination of the Michigan Innovation CD at a fixed exercise price.

Thus, the investors will begin receiving a return on their investment immediately instead of waiting for a liquidation event (e.g., 4 percent from the bank CD plus 4 percent from the enterprise). If the company is unable to pay the loan at the end of the term, the investors will lose their CDs. However, the investors could obtain an assignment of the security interest from the bank on any foreclosure by the bank. Alternatively, while it may seem harsh, allowing the unsuccessful companies to collapse at the end of the initial term of the loan may prevent a situation in which the company continues to operate on a marginal basis year after year, without any return to the investors or any way for the investors to write off the investment.

Equity-Based Financing

In General

Equity-based venture transactions, whether completed by a venture capital fund or by angel investors, can consist of anything as simple as issuance of common stock to issu-

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ance of preferred shares with detailed and very proinvestor rights, preferences, and privileges. In any event, the issuing entity must comply with applicable federal and state securities laws, the analysis of which is beyond the scope of this article. Exhibit 4 is a basic term sheet for a private placement of series A preferred shares that outlines the basic rights, preferences, and privileges that are typically given to investors in a series A preferred round. Other than the preferred dividend and liquidation preference granted to the series A preferred shares, most of these terms can be included in a funding round involving an issuance of common shares. Equity investment rounds are usually completed under a stock purchase agreement that includes typical representations and warranties similar to those found in a merger or acquisition transaction.

If the issuing entity has already completed a series A round, typically a follow-on round will then involve either the issuance of additional series A shares (hopefully at a higher per share purchase price) or the issuance of series B shares, with rights, preferences, and privileges superior to those granted to the series A shareholders.

Discussed below are a few of the typical provisions in a series A round, each of which are included in the term sheet attached as exhibit 4.

Valuation

The first task in completing a financing round is to determine the amount that needs to be raised, the minimum investment required, and a premoney valuation of the enterprise. When determining the amount to be raised, conventional wisdom dictates that the parties involved should create a pro forma list of expenses that the enterprise is likely to incur to cause the enterprise to fully complete its next stage of growth. One of the worst things that can happen to an early-stage enterprise is not obtaining enough funding to complete its contemplated stage of growth or spending the raised funds too quickly, causing the enterprise to have to go back to the venture capital market too soon. Accordingly, accurately defining the current scope and stage of the company's growth is essential. The primary goal should be to ensure that the company's value is significantly increased during the period in question. This may mean completion of a prototype, proof of market

acceptance by obtaining certain sales levels, reaching a gross revenue target, or, the ultimate goal, becoming profitable.

Establishing the premoney valuation of the enterprise is often one of the most enlightening experiences that a founder will go through in obtaining early-stage funding. Venture capital firms are driven to provide a specified return to their investors, which in turn causes the venture capital firm to analyze the company's business plan with an eye toward the likely return on investment. This likely return on investment is used to establish the premoney valuation (by subtracting the amount to be invested from the likely return). This process can lead to complicated and drawn-out negotiations between the venture capital firm and the entrepreneurs. Notwithstanding this process, in the end, the premoney valuation is most often established by the basic capitalistic tenet of what the willing buyer and the willing seller are able to agree to. Specifically, company founders are often not willing to sell their business idea for too high of an equity percentage given to investors. Based on this author's experience participating in dozens of early-stage funding rounds, founders tend to target a premoney valuation that will yield a 20–40 percent equity position to the investors as long as they are able to use the funds to move the company significantly forward. Founders are not always successful in this goal. Early-stage investors sometimes end up with over 40 percent of the equity of the enterprise and, in some cases, majority control. During the past two years in Michigan, many founders have had to settle for a minority position in the enterprise to obtain any seed funding to see their business idea developed.

Common Shares

Some preferred share rounds will also include common shares issued to the investors at a nominal per share price. This offers a way to increase the value of the round to the investors without the heavy price to the founders of selling the entire round in preferred stock.

Preferences – Dividends and Liquidation Payments

Most preferred rounds include a dividend accrual of between 6 and 15 percent that accumulates for the benefit of the preferred holders, but is not paid until a liquidation event (a merger, sale of substantially all assets, reor-

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ganization, or another transaction in which control of the enterprise is transferred, and in some cases an initial public offering). The dividend accrual is generally seen as the first-level return on investment.

In addition to the dividend accrual, preferred holders are given a liquidation preference such that their original investment plus the accrued dividend is paid to them on liquidation before any payments to the common shareholders. In addition, the preferred shares may be given a liquidation multiplier such that they will receive two, three, or four times their original investment, plus the accrued dividend, before any liquidation payments to common shareholders.

Finally, preferred shares are either *participating preferred* or *nonparticipating preferred*. Participating preferred shares participate on a pro rata basis with common shareholders on all liquidation payments made after the preferred payments have been made to the preferred shareholders. Nonparticipating preferred shareholders will only receive their liquidation preference payments (the investor's original investment, any liquidation multiplier, plus accrued dividends). The common shareholders receive all remaining assets on liquidation.

Antidilution

There are two typical types of antidilution protections that are normally included in preferred rounds. The main goal of antidilution protection is to provide the preferred holders with protection against dilution if shares in the issuing company are sold at a later date for a price that is lower than that paid by the preferred holders. If that occurs, there are two methods to protect the preferred holders, both of which result in a lowering of the conversion price that is used to convert the preferred shares to common shares upon a liquidation event or if the company goes public. The first method is commonly referred to as the weighted average method, under which a formula is used to lower the conversion price based on the number of outstanding shares before the new share issuance at the lower price, the number of new shares sold under the lower-price round, and the per share price under the lower-price round. The second method is referred to as the full-ratchet method, in which the conversion price is lowered to the share price offered under the new lower-price round.

Affirmative and Negative Covenants

Preferred holders are normally provided with certain negative and affirmative covenants. The negative covenants usually take the form of voting rights that require a certain percentage of the preferred shareholders' approval for specified transactions, such as large capital expenditures, deviations from annual budgets approved by the board, the issuance of new securities, the issuance of securities having a preference to the preferred shares issued under the current round, and the like. The affirmative covenants usually include rights of inspection and receipt of financial statements and requirements that an audit be performed and that the issuing entity comply with standard business practices such as filing tax returns, paying taxes, obtaining appropriate insurance, and complying with applicable laws.

Registration Rights

Preferred shareholders are also often provided with a variety of rights that apply after the company has completed an initial offering of its shares. These include a right to register the shares held by the preferred holder, a right to force the company to complete an initial public offering, piggyback rights (a right to participate in secondary offerings by the company), and rights aimed toward facilitation of a sale under Rule 144 of the U.S. Securities and Exchange Commission of unregistered shares held by the investor after the company has gone public.

Shares Restrictions

Preferred equity rounds normally include provisions affecting the founders' ownership of their common shares. These provisions include a right of first refusal given to the investors if any founder attempts to sell his or her shares. Perhaps most disturbing to many founders, investors often require the founders to vest into their shares over a four-year period after the investment is first made. If a founder's employment with the company is terminated, the founder will only be entitled to keep the vested shares as of the date of termination. Vesting can occur ratably on a month-by-month basis, ratably on a yearly basis, based on revenue milestones, or any other determinable event or events.

Board of Directors

Investors often require one or more seats on the company's board of directors. Usually

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director positions are grouped into three categories: (1) directors nominated by the common shareholders, (2) directors nominated by the preferred shareholders, and (3) joint directors. The joint directors are usually nominated by mutual agreement of the common directors and preferred directors, by a specified supermajority vote, or by a majority of the common shareholders and the preferred shareholders each voting as a separate class.

Use of Proceeds

The definitive documents will also require the company to limit the use of the investment proceeds to working capital and general corporate purpose (and perhaps other specified items).

Debt-Based Financing

In General

Debt-based financing for a start-up or early-stage enterprise can take many forms, ranging from a simple unsecured promissory note to heavily negotiated note purchase agreements in conjunction with secured convertible debt and additional warrants issued to the investor. Exhibit 5 is a sample term sheet for a debt financing round that includes many of the standard terms for a more formal debt issuance by a start-up or early-stage company. Usually, in more structured debt arrangements, the transaction occurs pursuant to a note purchase agreement, which contains a full set of representations and warranties much like that of a series A preferred round (or any typical merger or acquisition transaction).

Promissory Note and Security

The note purchase agreement will call for secured promissory notes to be issued to each investor with a stated interest rate and maturity date. The investors will enter into an intercreditor agreement to hold the security interest in the company's assets on a *pari passu* basis among all investors. The intercreditor agreement may also nominate one of the investors as agent for the other investors in case of default.

The promissory note may also be convertible into shares of the company at a stated rate or pursuant to a set formula. The conversion could occur at a set maturity date, liquidation event, election by the investors at any

time, election by the board of directors at any time, or some other specified event.

Warrants

Most debt financing rounds will include warrants issued to the investors to purchase company shares at terms that are similar to those described above for convertible debt. It is most common to see warrants treated as additional compensation to the investors over and above other terms of the debt transaction, including interest payments or any provisions calling for conversion of the debt to equity. The three most common exercise prices seen for warrants issued under a debt round include:

- a nominal exercise price,
- an exercise price established pursuant to a current valuation of the enterprise, and
- an exercise price set at the per-share price under the next equity round of investment into the company.

Other Terms

In addition to the above, debt-round financing will often include the nonshare specific terms outlined above for equity round financing, including, without limitation, affirmative and negative covenants, registration rights for shares received on conversion of the notes or exercise of the warrant, limitations on founder equity, board of director control provisions, and the like.

Conclusion

Michigan early-stage venture capital markets are active and full of opportunities. Each transaction brings new twists and turns that make working in this environment very rewarding. It is very exciting to see a new enterprise obtain financing and to assist in negotiations to bring all parties to the table for a successful closing. There is no right or wrong way to complete early-stage financing. This article simply attempts to outline some of the more prevalent methods currently used. Good luck to all investors and all entrepreneurs, and may all your future rounds be up rounds.

NOTES

1. Other types of venture capital markets are not discussed in this article, such as venture capital funding targeted toward more mature companies or funding targeted toward taking a controlling interest in the issuing entity.

Preferred equity rounds normally include provisions affecting the founders' ownership of their common shares. . . . Investors often require one or more seats on the company's board of directors.

2. Information technology being the underlying technology upon which a business enterprise is based, for example, software, pharmaceuticals, medical devices, patented technology, Internet applications, trade secrets, know-how, and the like.

3. To learn the meaning of other venture capital terms, visit either of these Web sites: <http://vcexperts.com/vce/library/encyclopedia/glossary.asp> or <http://www.fundingpost.com/glossary/venture-glossary.asp>.



Timothy R. Damschroder is a partner in the Ann Arbor office of Bodman, LLP. He is a business lawyer with a concentration on early-stage enterprises and corporate finance. During 2004,

Mr. Damschroder closed over one dozen venture capital and angel investments on behalf of either the issuing entity or the funding group or entity. His corporate finance work includes debt and equity financing (venture capital and angel investments) and derivative transactions including ISDA documentation, master agreements, interest rate swaps, currency swaps and other foreign exchange transactions, and options. Mr. Damschroder is a frequent lecturer for ICLE and a contributor to Michigan Contract Law (ICLE 1998 and supplements). He is also a past chairperson of the Business Law Section of the State Bar of Michigan. He is a member of the International Law and Practice and Business Sections of the American Bar Association. Mr. Damschroder serves on the board of directors of Nonprofit Enterprise at Work and Peace Neighborhood Center, both of Ann Arbor.

Exhibit 1

Michigan-Based Venture Capital Funds

No.	Name	Location	Web Site / Information
1.	Arbor Partners LLC	Ann Arbor	arborpartners.com
2.	Arboretum Ventures	Ann Arbor	arboretumvc.com
3.	Aurora Angels	Petoskey	auroraangels.com
4.	Beringea LLC	Farmington Hills	beringea.com
5.	Center for Venture Capital and Private Equity Finance	Ann Arbor	bus.umich.edu/cvp
6.	Dearborn Capital Corporation	Dearborn	dearborncapitalcorp.com
7.	Detroit Investment Fund	Detroit	detinvfund.com
8.	Detroit Technology Ventures	Bloomfield Hills	
9.	Draper Fisher Jurvetson	Ann Arbor	www.wdc-econdev.com/financials.html
10.	EDF Ventures	Ann Arbor	edfvc.com
11.	Essex Woodlands Health Ventures	Ann Arbor	michigan.craintech.com
12.	Great Lakes Angels	Bloomfield Hills	angel-investor-network.com/Great-Lakes-Angels
13.	MedCap Leasing, LLC	Troy	
14.	North Coast Technology Investors	Ann Arbor	northcoastvc.com
15.	Parr Enterprises, LLC	Rochester Hills	michigan.craintech.com
16.	Ralph Wilson Equity Fund	Grosse Pointe Park	rwequity.com
17.	Sandab Group	Birmingham	sandab.com
18.	Sloan Ventures, LLC	Birmingham	sloanventures.com
19.	Syneptics	Ann Arbor	syneptics.com
20.	Telkite Inc	Gwinn	
21.	The Toxicology Group, LLC	Ann Arbor	npicenter.com/listings
22.	Tullis-Dickerson & Co., Inc.	Ann Arbor	michigan.craintech.com
23.	Waypoint Ventures	Ann Arbor	wpvc.com
24.	White Pines Ventures, LLC	Ann Arbor	whitepines.com
25.	Wind Point Partners	Southfield	hoovers.com/wind-point-partners/--ID__114949--/free-co-factsheet.xhtml

Source for chart: Michigan Economic Development Corporation

Exhibit 2

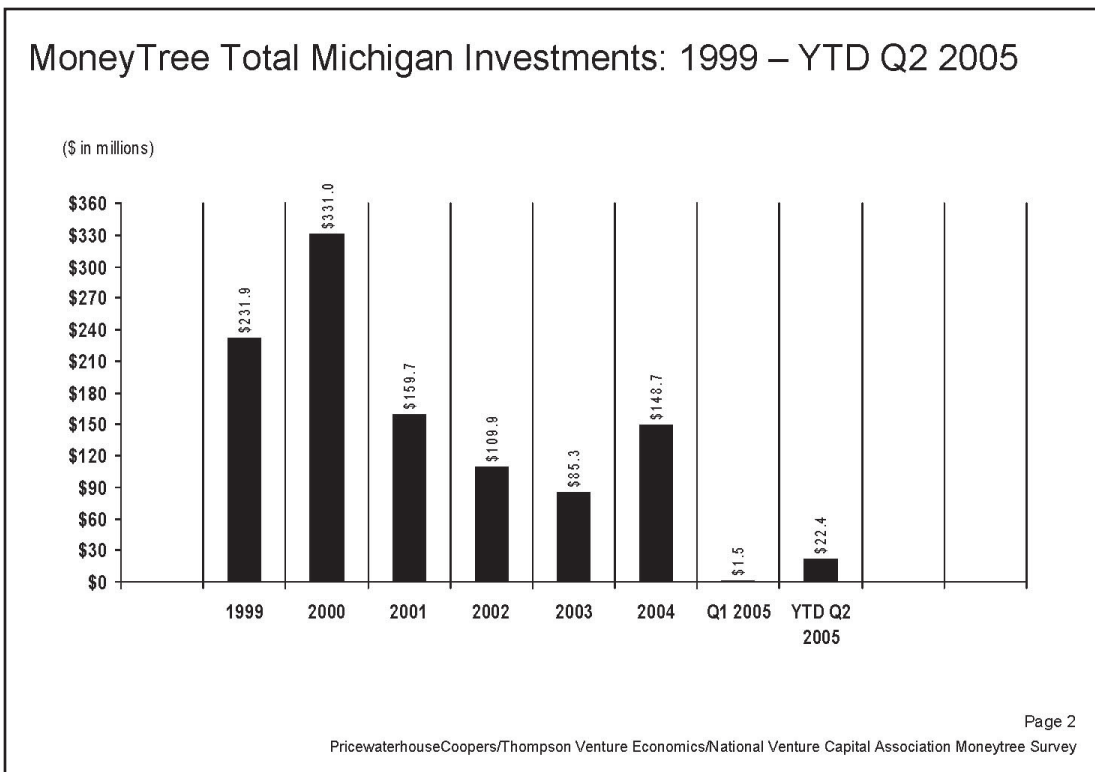
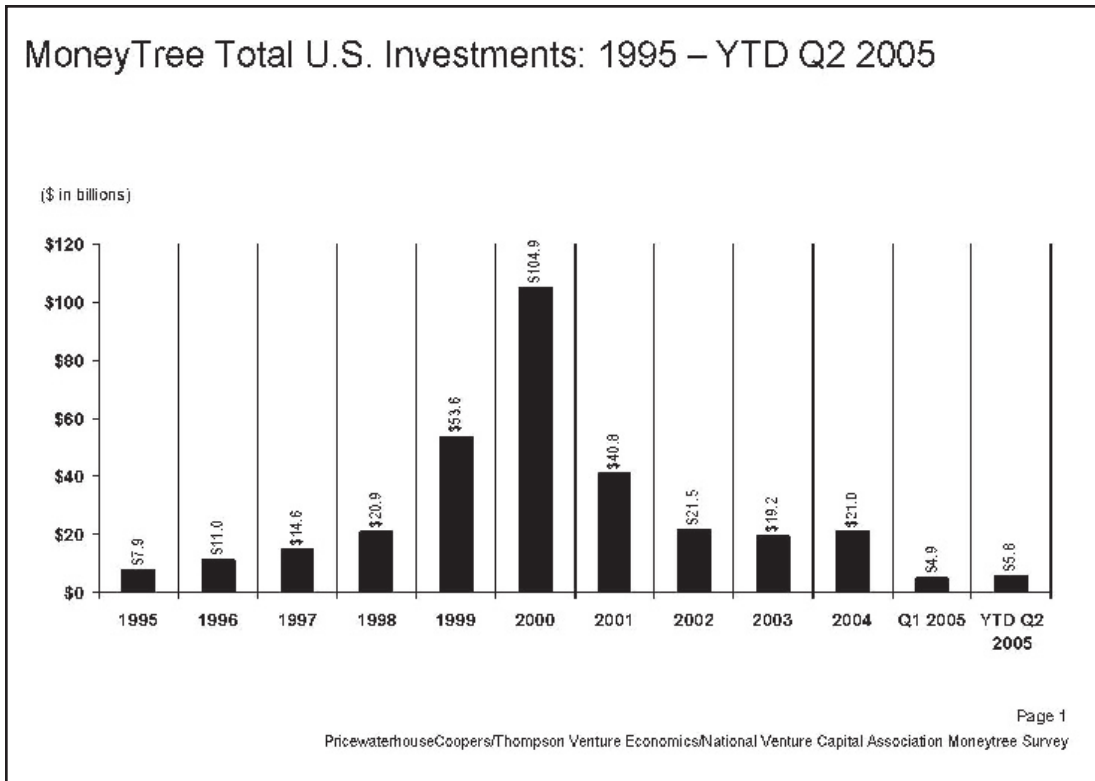
Michigan Venture Capital Transactions 2004

2004/2005 Qtr	Issuing Entity	City	Amount Raised	Disclosed Investors
2005 Qtr 2	Assay Designs, Inc.	Ann Arbor	\$5,000,000	Ampersand Ventures
2005 Qtr 2	Asterand, Inc. (f/k/a BioSampleX Pharmaceuticals)	Detroit	\$3,500,000	<ul style="list-style-type: none"> • Chrysalis Ventures • Fort Washington Capital Partners LLC • ApJohn Ventures, LLC • Arboretum Ventures
2005 Qtr 2	ISD Corp. (a/k/a Integrated Systems Development)	Holland	\$6,000,000	<ul style="list-style-type: none"> • River Cities Capital Funds • Odin Capital Group • Nationwide Mutual Capital, LLC • Prism Capital
2005 Qtr 2	ProNAi Therapeutics, Inc.	Kalamazoo	\$525,000	• ApJohn Ventures, LLC
2005 Qtr 2	STM Power, Inc. (f/k/a Stirling Thermal Motors)	Ann Arbor	\$7,400,000	<ul style="list-style-type: none"> • VantagePoint Venture Partners • CDP Capital Technology Ventures (f/k/a CDP Sofinov) • Smart Technology Ventures
2005 Qtr 1	Northcoast PCS	Detroit	\$403,000	Primus Venture Partners, Inc.
2005 Qtr 1	ProNAi Therapeutics, Inc.	Kalamazoo	\$1,125,000	ApJohn Ventures, LLC
2004 Qtr 4	Altair Engineering, Inc.	Troy	\$30,000,000	• General Atlantic Partners, LLC
2004 Qtr 4	ArborText, Inc.	Ann Arbor	\$6,000,000	<ul style="list-style-type: none"> • Norwest Venture Partners • North Coast Technology Investors, LP
2004 Qtr 4	Qualitor, Inc.	Southfield	Not disclosed	<ul style="list-style-type: none"> • Baird Capital Partners • Thayer Capital Partners
2004 Qtr 4	QUATRx Pharmaceuticals Company (f/k/a Pegasus Pharmaceutical)	Ann Arbor	\$15,350,000	<ul style="list-style-type: none"> • MPM Capital • InterWest Partners • Thomas Weisel Venture Partners • Frazier Healthcare and Technology Ventures
2004 Qtr 4	QUATRx Pharmaceuticals Company (f/k/a Pegasus Pharmaceutical)	Ann Arbor	\$14,500,000	<ul style="list-style-type: none"> • MPM Capital • InterWest Partners • TL Ventures • Frazier Healthcare and Technology Ventures • Twilight Venture Partners
2004 Qtr 4	Sensicore, Inc.	Ann Arbor	\$12,000,000	<ul style="list-style-type: none"> • NGEN Partners LLC (f/k/a NextGen Partners, LLC) • TopSpin Partners • Technology Partners
2004 Qtr 3	Data TV Networks	Ann Arbor	\$1,190,000	<ul style="list-style-type: none"> • Undisclosed venture firm • KB Partners, LLC
2004 Qtr 3	Dellego Technologies (f/k/a QSSolutions Engineered Systems)	Royal Oak	\$1,500,000	• Undisclosed venture firm
2004 Qtr 3	HandyLab, Inc.	Ann Arbor	\$5,000,100	<ul style="list-style-type: none"> • EDF Ventures Partners (a/k/a Sigefi, Burnette & Vallee) • SBV Venture P • University of Michigan • Ardesta • DuPont Pharmaceuticals • XR Ventures (a/k/a X Rite Ventures) • Arboretum Ventures
2004 Qtr 3	InterLink Networks	Ann Arbor	\$2,850,000	<ul style="list-style-type: none"> • Duchossois Technology Partners, LLC • Undisclosed venture firm • Arbor Partners, LLC
2004 Qtr 3	Northcoast PCS	Detroit	\$2,500,000	• Primus Venture Partners, Inc.

2004/2005 Qtr	Issuing Entity	City	Amount Raised	Disclosed Investors
2004 Qtr 2	Genetics Squared, LLC	Milan	\$1,000,000	• CrystalPoint Partners
2004 Qtr 2	Mobius Microsystems, Inc	Ann Arbor	\$1,000,000	• Undisclosed venture firm • University of Michigan
2004 Qtr 2	Aveso, Inc (f/k/a Com-motion, Inc.)	Franken-muth	\$5,000,000	• Arch Venture Partners • Frazier Healthcare and Technology Ventures
2004 Qtr 2	Akonni Biosystems	Gregory	\$50,000	• Maryland Technology Development Corp. (TEDCO)
2004 Qtr 1	Michigan Seamless Tube (a/k/a Metal Resources, LLC)	South Lyon	\$2,900,000	• Northwood Ventures
2004 Qtr 1	EcoSynthentix, Inc.	Lansing	\$8,700,300	• Undisclosed venture firm • HB Fuller Ventures • Tera Capital Corporation • Cargill Ventures • Skylon Capital
2004 Qtr 1	STM Power, Inc. (f/k/a Stirling Thermal Motors)	Ann Arbor	\$24,300,100	• Vantage Point Venture Partners • CDP Capital Technology Ventures (f/k/a CDP Sofinov) • Sempra Ventures • Smart Technology Ventures • Nth Power
2004 Qtr 1	Nexcerpt, Inc.	Kalamazoo	\$25,000	• ARCH Development Partners, LLC
2004 Qtr 1	Discera, Inc.	Ann Arbor	\$12,200,000	• Partech International • Ardesta • 3i (US) • Qualcomm Ventures
2004 Qtr 1	HealthMedia, Inc.	Ann Arbor	\$1,000,000	• Chrysalis Ventures • Undisclosed investors
Total			\$171,018,500	

Source: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Money Tree™ Survey, at www.pwcmoneytree.com/moneytree/.

Exhibit 3 Invested Venture Capital



Source: PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Money Tree™ Survey, at www.pwcmoneytree.com/moneytree/

Exhibit 4

Memorandum of Terms for Private Placement of Series A Preferred Stock

<i>Issuer:</i>	Big Idea, Inc., a Michigan corporation
<i>Amount of financing:</i>	\$2,000,000
<i>Closing:</i>	The first closing will occur on a minimum amount raised of \$1,000,000.
<i>Minimum investment:</i>	\$25,000
<i>Premoney value:</i>	\$5,000,000 on a fully diluted basis (including employee stock option plan as reflected on the attached capitalization schedule)
<i>Lead investor:</i>	Big Money Ventures, LP
<i>Security issued and price:</i>	Series A convertible preferred stock (Series A Stock) issued at \$1 per share (based on \$2,000,000 invested) [plus Common Stock issued at \$0.001 per share]

Terms of Series A Stock

<i>Dividends:</i>	Annual [8 %] dividend on the Series A Stock, payable when and if declared by the board; unpaid dividends will accumulate until paid (but will not compound into the original investment amount).
<i>Liquidation preference:</i>	<p>In the event of any liquidation or winding up of the Company, the holders of the Series A Stock will be entitled to receive their original purchase price plus any declared but unpaid dividends on each series (the Liquidation Preference), in preference to the holders of Common Stock.</p> <p>After the above distribution, the holders of Series A Stock and Common Stock will share any distributions on a pro rata basis until Series A Stock has received [two times] the Liquidation Preference. After that, all assets will be distributed to holders of the Common Stock.</p> <p>[Alternative language: After the above distribution, the holders of Series A Stock and Common Stock will share all remaining distributions on a pro rata basis as if all Series A Stock were converted to Common Stock.]</p> <p>A merger, sale of substantially all assets, reorganization, or other transaction in which control of the Company is transferred will be treated as a liquidation.</p>
<i>Conversion:</i>	Subject to adjustment as set forth below, each share of the Series A Stock is convertible into one share of Common Stock (1) at the option of any holder of it, (2) automatically on closing of a firmly underwritten public offering of Common Stock on Form S-1 at a public offering price of at least [3] times the original per-share purchase price, with gross proceeds to the Company of more than \$[amount]; and (3) automatically on the consent of holders of a majority of the then outstanding shares of Series A Stock.
<i>Antidilution adjustments:</i>	The conversion ratio of each series of Preferred Stock will be adjusted on a weighted-

average basis for issuances below conversion price of Series A Stock, other than (1) the issuance of shares of Common Stock to employees, directors, and consultants under plans or agreements unanimously approved by the board of directors; (2) the sale of shares of the Company's capital stock (or rights for it) to financial institutions or lessors in connection with credit and equipment financing arrangements unanimously approved by the board of directors; (3) the sale of shares of the Company's capital stock (or rights for it) to strategic

partners in connection with bona fide corporate partnering arrangements unanimously approved by the board of directors; and (4) the issuance of the Company's capital stock (or rights for it) in connection with acquisitions and mergers unanimously approved by the board of directors.

In the event of any stock split, stock dividend, combination, or the like, the conversion price of the Series A Stock will be appropriately adjusted.

Voting rights:

The Series A Stock votes with the Common Stock on an as-converted basis, but the approval of a majority of the holders of the Series A Stock will be required for any (1) change in the aggregate number of authorized shares of Common Stock, Series A Stock, or any series of Preferred Stock; (2) exchange, reclassification, or recombination of any outstanding shares into securities having rights, preferences, or privileges prior to or pari passu with the Series A Stock; (3) change in the rights, preferences, privileges, or restrictions on any series of Preferred Stock; (4) creation of a new class of shares having rights, preferences, or privileges prior to or pari passu with the Series A Stock; (5) declaration or payment of a dividend on the Common Stock or any series of Preferred Stock (other than a dividend payable solely in shares of Common Stock); (6) redemption of any shares of any series of Preferred Stock or Common Stock (other than repurchases on termination or pursuant to rights of first refusal); or (7) liquidation, dissolution, or change of control (by merger, sale of assets, or otherwise) of the Company. In addition, Series A Stock will have separate series voting rights as provided by Michigan law.

Purchase Agreement

Representations and warranties:

Standard representations and warranties.

Right of pro rata participation:

Investors holding at least [100,000] Shares and each of _____ (the Founders) will have the right to participate in future financings to maintain their pro rata percentage of the Company's shares then outstanding (subject to the same carveouts for antidilution).

Investors' Rights Agreement

Registration rights:

1. Beginning [five] years after the closing of the initial sale of the Shares, two demand registrations on initiation by the holders of at least [40%] of the Shares. Expenses (other than underwriting discounts) paid by Company.
2. Unlimited piggybacks, subject to pro rata cutback to a minimum of [25%] of the offering at the underwriter's discretion, with possible complete cutback on initial public offering. Expenses (other than underwriting discounts) paid by Company. Each of the Founders will be entitled to participate in such piggyback registrations on the same terms as the Investors.
3. Two S-3 registrations of at least [\$500,000] per year when the Company becomes eligible. Expenses (other than underwriting discounts) paid by the Company.
4. Agreement to provide for up to [180-day] post-initial public offering lockup as may be required by the underwriters selected by the Company.

Financial information:

All Investors have the right to receive audited annual financial statements. Investors holding more than [100,000] Shares are also entitled to receive monthly unaudited financials and ann-

ual budget as well as standard inspection rights. Rights terminate on the Company's initial public offering.

Transfer of rights: Registration or information rights may only be transferred to affiliates, to existing stockholders, or to holders (after the transfer) of at least [100,000] Shares.

Cosale agreement: Investors have a right of first refusal (subordinate to the Company's right of first refusal) on sales of the Company's securities by the Founders. If the right of first refusal is waived, the Investors will be entitled to participate (on a pro rata basis) in any sales of securities of the Company by any of the Founders to a third party on the same terms as the Founders.

Employee Matters

Common stock: All restricted stock and stock options issued to employees are subject to [four-year] vesting with a [one-year] cliff. Vesting of initial options or restricted stock granted to employees will commence on the date of employment with the Company.

The shares initially granted to the Founders (the Founders' Shares) will be subject to vesting based on a [five-year] schedule, which is deemed to have commenced on the date [two years] prior to the closing of the financing (such that [40%] of the Founders' Shares are vested at that time).

Invention assignment agreements: Each of the employees of the Company (including the Founders) will execute Confidentiality and Inventions Assignment Agreements with the Company in an acceptable form.

Miscellaneous

Board of directors: The board of directors is set at [TBD] members. Board composition at the Closing Date will be [2] members elected by holders of Common Stock (who initially will be [name] and [name]), and [2] members elected by holders of Series A Stock (who initially shall be [name] and [name]).

Use of proceeds: The Company must use the investment proceeds for working capital and general corporate purposes and may not apply any of these proceeds to the reduction of previously incurred debt, payment of any bonuses, or back pay to any employees or independent contractors.

Expenses: If the financing is completed, the Company will pay the reasonable legal fees (subject to a maximum of \$ [amount] and expenses of [law firm], counsel for [Big Money Ventures], in connection with the transaction.

Closing conditions: Standard closing conditions, including satisfactory completion of due diligence, customary legal opinions, etc.

This Memorandum of Terms is intended as a summary and is for discussion purposes only. Neither party has an obligation to the other until the execution of definitive agreements relating to the transaction contemplated in this memorandum. However, (1) the parties agree to work together in good faith with respect to the transactions contemplated in this memorandum, (2) the parties agree to maintain the confidentiality of the terms in this memorandum, and (3) the Company agrees not to solicit, encourage, or entertain offers from alternate sources of funding during the 60-day period following the execution of this Memorandum of Terms.

Big Idea, Inc.

By: _____

Title: _____

Big Money Ventures, LP

By: _____

Title: _____

Exhibit 5

Memorandum of Terms for Private Placement of Secured Debt Issuance BIG IDEA, LLC

Summary

<i>Issuer:</i>	Big Idea, LLC, a Michigan limited liability company (the Company).
<i>Amount of financing:</i>	\$1,500,000
<i>Closing:</i>	The first closing will be for at least \$600,000 and will close on [date].
<i>Minimum investment:</i>	\$25,000
<i>Lead investor:</i>	Big Money Ventures, LP
<i>Security issued:</i>	Convertible secured promissory note.

Terms of Secured Debt Issuance

<i>Convertible secured promissory note:</i>	The Company will issue convertible secured promissory notes (each, a Note). Each Note will bear interest at 8½ percent per year. Subject to prior conversion of each Note as described below, all unpaid principal and interest under each Note is due and payable on the earlier of (1) [60 months] (the Maturity Date), provided that Investor has given written notice to the Company on or after [54 months], but before the Maturity Date, demanding full payment of the Note as of the Maturity Date or (2) when the amounts are declared due and payable by the Investor on or after the occurrence of an event of default under the terms of the Note. The Note is convertible into a membership interest in the Company voluntarily by Investor at any time before the Maturity Date or automatically on the Maturity Date, provided that the Investor has not given written notice to the Company on or after [54 months] but before the Maturity Date, demanding full payment of the Note as of the Maturity Date. The Conversion Price for each Note is [\$45,000] per [1%] of membership interest in the Company (the Conversion Price). The Conversion Price is based on a premoney valuation of [\$3,000,000] and total investment for all Notes of [\$1,500,000].
<i>Security:</i>	Each Note will be secured by a lien on substantially all of the assets of the Company in accordance with the Intercreditor Agreement described below and subject to the right of the Company in its sole discretion to subordinate the Note and its security by granting up to two security interests to one or two commercial banks that are superior in priority to the security interests granted under the Note (provided that the subordination does not exceed [\$2,000,000] in the aggregate). The transaction will be subject to each Investor becoming a party to an Intercreditor Agreement among the Company and the Investors under which each Investor agrees to hold its security interest on a pari passu basis with all other Investors.
<i>Warrant:</i>	As a part of the transaction, the Company will grant to Investor a warrant to purchase a membership interest in the Company at the Conversion Price, with the warrant being exercisable on or before [10 years]. The warrant will enable all Investors to purchase an aggregate [10%] membership interest in the Company.
<i>Negative covenants:</i>	Without the approval of the holders of a majority of the total outstanding principal on the Notes, the Company may not (1) merge or consolidate with or into, or permit any subsidiary to merge or consolidate with or into, any other corporation or other entity or entities; (2) reorganize, dissolve,

or liquidate the Company or adopt any plan of reorganization, dissolution, or liquidation of the Company; (3) acquire voting stock or assets of another corporation or other entity or entities; (4) authorize or issue additional membership interests of the Company other than pursuant to the Company employee option plan or a strategic business relationship approved by the Company's board of directors; (5) incur, create, assume, reclassify, or guarantee any indebtedness that ranks senior or pari passu in the right of payment to the Notes; (6) amend the Articles of Organization or Operating Agreement; (7) effect any material change in the nature of the business of the Company or apply the assets of the Company other than for the conduct of the business of the Company as that business is conducted and proposed to be conducted; (8) sell, lease, transfer, or otherwise dispose of any of its assets outside the ordinary course of business or sell, lease, transfer, or otherwise dispose of any of its intellectual property, except for the grant of nonexclusive licenses entered into in the ordinary course of the Company's business; (9) make any loan, extension of credit, or capital contribution to or purchase any membership interest, bonds, notes, debentures, or other securities of or any other investment in any other entity; or (10) acquire, own, or create any subsidiary of the Company or take any action through a subsidiary that is prohibited under these covenants.

Employee Matters

Invention assignment agreements: Each of the employees of the Company (including the Founders) will execute Confidentiality and Inventions Assignment Agreements with the Company in an acceptable form.

Miscellaneous

Board of directors: The board of directors is set at [three] members. Board composition at the Closing Date will be [one] member elected by holders of the Notes (who initially will be [name] and [name]), and [two] members elected by the members of the Company (who initially will be [name] and [name]).

Use of proceeds: The Company must use the investment proceeds for working capital and general corporate purposes and may not apply any of these proceeds to the reduction of previously incurred debt, payment of any bonuses, or back pay to any employees or independent contractors.

Financial information: All Investors will have the right to receive audited annual financial statements, monthly unaudited financials, and annual budgets as well as standard inspection rights. Rights terminate on the Company's initial public offering.

Expenses: If the financing is completed, the Company will pay the reasonable legal fees (subject to a maximum of [\$20,000]) and expenses of [law firm], counsel for Big Money Ventures, LP, in connection with the transaction.

Closing conditions: Standard closing conditions, including satisfactory completion of due diligence, customary legal opinions, etc.

This Memorandum of Terms is intended as a summary and is for discussion purposes only. Neither party has an obligation to the other until the execution of definitive agreements relating to the transaction contemplated in this memorandum. However, (1) the parties agree to work together in good faith with respect to the transactions contemplated in this memorandum, and (2) the parties agree to maintain the confidentiality of the terms contained in this memorandum.

Big Idea, Inc. Big Money Ventures, LP

By: _____ By: _____

Title: _____ Title: _____