Venture Capital Lexicon

**Anti-dilution Protection (also known as Anti-dilution provisions):** In the event of a down-round financing (i.e. when new convertible preference shares are issued at a lower price than an earlier round), existing preferred shareholders with anti-dilution protection are compensated through the adjustment of the conversion ratio from preference to ordinary shares. Common formulae used are:

1. Broad-based Weighted Average Anti-dilution:

CP2 = CP1 \* (A+B) / (A+C)

CP2 = Series A Conversion Price in effect immediately after new issue (a reference to a new issue in this formula being a reference to the down-round)

CP1 = Series A Conversion Price in effect immediately prior to new issue

A = Number of Ordinary Shares outstanding immediately prior to new issue (includes outstanding ordinary shares, all shares of outstanding preference shares on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing)

B = Aggregate investment in new round of financing divided by CP1

C = Number of shares of stock issued in the new round

**Broad-based Weighted Average Anti-dilution Example:**

Techco raised two rounds of financing:

Series A round of $5.00m at $1.00/share and Series B round of $8.00m at $0.80/share.

Post Series A Investment:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Shareholder** | **Investment** | **Price/Share** | **Preference**  **Shares** | **Conversion Price/Share** | **As Converted to Common Shares** | **Ownership** |
| Ordinary |  |  |  |  | 20.00m | 80.00% |
| Series A | $5.00m | $1.00 | 5.00m | $1.00 | 5.00m | 20.00% |
| Total |  |  |  |  | 25.00m | 100.00% |

Post Series B Investment (Series A without Anti-Dilution):

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Shareholder** | **Investment** | **Price/Share** | **Preference**  **Shares** | **Conversion Price/Share** | **As Converted to Common Shares** | **Ownership** |
| Ordinary |  |  |  |  | 20.00m | 57.14% |
| Series A | $5.00m | $1.00 | 5.00m | $1.00 | 5.00m | 14.29% |
| Series B | $8.00m | $0.80 | 10.00m | $0.80 | 10.00m | 28.57% |
| Total |  |  |  |  | 35.00m | 100.00% |

Post Series B Investment (Series A with Broad-based Anti-Dilution):

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Shareholder** | **Investment** | **Price/Share** | **Preference**  **Shares** | **Conversion Price/Share** | **As Converted to Common Shares** | **Ownership** |
| Ordinary |  |  |  |  | 20.00m | 56.65% |
| Series A | $5.00m | $1.00 | 5.00m | $0.9429 | 5.30m | 15.02% |
| Series B | $8.00m | $0.80 | 10.00m | $0.80 | 10.00m | 28.33% |
| Total |  |  |  |  | 35.30m | 100.00% |

1. Narrow-based Weighted Average Anti-dilution:

Uses the same formula as Broad-based Weighted Average Anti-dilution except for variable A which is redefined more narrowly:

A = Number of Ordinary Shares outstanding immediately prior to new issue (only includes all preference shares on an as-converted basis for the series being adjusted)

**Narrow-based Weighted Average Anti-dilution Example:**

Post Series B Investment (Series A with Narrow-based Anti-Dilution):

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Shareholder** | **Investment** | **Price/Share** | **Preference**  **Shares** | **Conversion Price/Share** | **As Converted to Common Shares** | **Ownership** |
| Ordinary |  |  |  |  | 20.00m | 55.91% |
| Series A | $5.00m | $1.00 | 5.00m | $0.8667 | 5.769m | 16.13% |
| Series B | $8.00m | $0.80 | 10.00m | $0.80 | 10.00m | 27.96% |
| Total |  |  |  |  | 35.769m | 100.0% |

1. Full Ratchet Anti-dilution:

The conversion price will be reduced to the price at which the new shares are issued.

**Full Ratchet Anti-dilution Example:**

Post Series B Investment (Series A with Full Ratchet Anti-Dilution):

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| **Shareholder** | **Investment** | **Price/Share** | **Preference**  **Shares** | **Conversion Price/Share** | **As Converted to Common Shares** | **Ownership** |
| Ordinary |  |  |  |  | 20.00m | 55.17% |
| Series A | $5.00m | $1.00 | 5.00m | $0.80 | 6.25m | 17.24% |
| Series B | $8.00m | $0.80 | 10.00m | $0.80 | 10.00m | 27.59% |
| Total |  |  |  |  | 36.25m | 100.0% |

**\* The Number of Series A shares does NOT change. Only the Conversion Price and hence the Conversion Ratio (Preference A to Common) changes.**

**Board Observer:** Board Observers have the right to be present at meetings of the board of directors and be informed of any decision of the board of directors but do not have the right to vote in board decisions. The rights of a Board Observer may be limited to observation only or broadened to include a right to speak and participate in discussions (without having a vote on the same at the end of the discussion).

**Conversion:** Preference shares that are issued to an investor are convertible to ordinary shares at any time at the option of the investor according to a conversion ratio. The shares are hence called *Convertible Preference Shares*. The initial conversion ratio at the time of investment is 1 preference share to 1 ordinary share but is subject to adjustments for share splits, consolidations, issue of share dividends, recapitalizations and anti-dilution provisions. The number of ordinary shares that will be issued upon conversion is calculated by dividing the aggregate original issue price of the preference shares by the conversion price (as adjusted from time to time pursuant to the anti-dilution provisions). Preference shares are subject to automatic conversion to Ordinary shares in the event of a qualifying IPO (i.e. an Initial Public Offering at a pre-determined amount raised and/or price per share). Other events which trigger automatic conversion may also be included (such as when a majority of the holders of the relevant preference shares approve a conversion).

**Cumulative Dividend:** A dividend which accrues to the next period if not paid in the current payment period. This dividend could be a fixed value or a percentage of the share’s original price to be remitted periodically to shareholders irrespective of the earnings or profitability of the company. Conversely, a non-cumulative dividend does not accrue if not paid (or declared). Dividends to preferred shareholders must be paid prior to any dividends to ordinary shareholders.

**Director:** Directors are appointed by shareholders of the company and supervise the affairs of the company and make crucial company decisions such as the issuance of dividends and, unless agreed otherwise between the shareholders, the appointment of key managers like the CEO, COO and CFO. Together as a board, the directors make key decisions about the company such as fundraising and sale of the company. Often, these major decisions are included under Reserved Matters and hence further subject to Protective Provisions which require the approval of shareholders (as explained under Reserved Matters or Protective Provisions below).

**Drag-Along Right:** A drag-along right is a right to compel other shareholders to sell their shares in certain circumstances. For example, in the event of an offer for all the shares of the company, preferred shareholders owning more than a certain threshold percentage (negotiated and determined at time of investment) who agree to sell can require all other shareholders to sell their shares on the same price and terms.

**Fully-diluted Basis:** Fully-diluted shares refer to the total number of outstanding Ordinary Shares assuming all convertible securities (including preference shares, warrants, convertible notes, and stock options) are converted. Whether or not treasury stock (not yet issued) is also included will need to be considered and negotiated.

**Indemnity:** An indemnity is security for potential loss or an exemption from liability for damages based on a contractual agreement made between two parties. It is where one party (the indemnifier) commits to pay for the losses or damages incurred by another party (the indemnified party) in certain circumstances as set out in the contract between them.

**Investment Agreement (also known as Subscription Agreement):** An agreement to subscribe for a new issuance of security. The Investment Agreement describes the type of security, the price and the terms and conditions relating to the subscription.

**Liability**: Refers to the responsibility of a person, business or organisation to pay or give up something of value. In contracts, liability can be-

1. Joint
2. Several or
3. Joint and Several

Joint Liability:

This occurs when two or more persons together promise to do something. There is only one obligation. However, all parties are on the hook for the entire amount until the obligation is fulfilled by any one or all parties.

Several Liability:

This occurs when two or more parties make separate promises to do something in the same contract or different contracts. No party shall have any obligation or liability for any actions taken or not taken or any claims made against any other party. Payment/fulfilment by one party does not discharge others.

Joint and Several Liability:

This occurs when two or more parties under the same contract together promise to do something and also contract separately to do the same thing. This gives rise to one joint obligation and several other separate obligations. Fulfilment by one party discharges all others, and that party may then seek contribution from the other joint and several obligors. If obligations are not fulfilled, the claimant can sue all parties jointly or each party separately.

**Liquidation or Liquidity Event:** In the context of a Term Sheet or Shareholders’ Agreement for an illiquid security (such as shares), a liquidation or liquidity event triggers the rights of Preferred Shareholders to exercise their Liquidation Preference. Hence, the definition of a liquidation or liquidity event is extremely important and specifically defined in the legal document. As a qualifying IPO (see definition of Conversion above) on an exchange triggers the automatic conversion of Preferred Shares to Ordinary, a qualifying IPO does not cause the exercise of liquidation preference and hence is excluded as a liquidation event for holders of Preferred Stock. However, an IPO is considered a liquidity event for holders of CARE documents as it can trigger the issue of Ordinary Shares or repayment.

Typically, a liquidation or liquidity event for Preference Shareholders includes:

1. A liquidation, dissolution or winding up of the Company.
2. A consolidation or merger of the Company with or into any other corporation or corporations or non-corporate business entity or any other corporate reorganization in which the shareholders of the Company immediately prior to such consolidation, merger or reorganization, own less than majority of the surviving or acquiring entity’s voting power immediate after such consolidation, merger or reorganization.
3. A sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the company or subsidiary(ies) of the company if all or substantially all of the assets of the company are held by such subsidiary(ies)
4. A transaction or series of transactions in which more than 50% of the voting power of the Company is transferred.

**Liquidation Preference:** Preferred Shareholders are entitled to exercise their liquidation preference rights upon the occurrence of a liquidation or Liquidity Event as defined above. A liquidation preference is the amount that must be paid to each series of preferred shareholders before distributions may be made to ordinary shareholders. The ranking of different series of preferred shareholders, the value as well as type of liquidation preference are often subjects for negotiation.

* **Ranking:** Later series of preference shares can rank above earlier series or rank pari passu or any other order as negotiated and recorded in the Shareholders’ Agreement.
* **Value:** The liquidation preference value is often expressed as a multiple of the original purchase price per share such as 1x, 2x etc.
* **Type:** Liquidation preference rights can be classified as:

1. **Non-participating Liquidation Preference:**

Upon the occurrence of a liquidation or liquidity event, preferred shareholders will have to choose either to exercise their liquidation preference rights i.e. receive a multiple of their initial investment amount (1x, 2x etc. as stipulated in their liquidation preference rights plus any dividends declared by unpaid thereon) **OR** convert their preference shares to ordinary (according to the prevailing conversion ratio) and receive a share of the proceeds according to their equity ownership of the company. Hence, preferred shareholders will choose whichever option maximizes their payout.

1. **Participating Liquidation Preference:**

Upon the occurrence of a liquidation or liquidity event, preferred shareholders will first receive a multiple of their initial investment amount (1x, 2x etc. as stipulated in their liquidation preference rights plus any dividends declared but unpaid thereon) **AND** in addition, receive a share of the proceeds together with ordinary shareholders as if they had converted their preference shares to ordinary.

**Liquidation Preference Payout Example:**

Techco raised two rounds of financing:

Series A round of $5m at $1/share with 1x **non-participating** liquidation preference and

Series B round of $18m at $3/share with 1x **participating** liquidation preference

Series B ranks ahead of Series A which ranks ahead of ordinary.

Management of Techco owned 9m ordinary shares.

Assuming no dividend has been declared on the liquidation date

Post Series B capitalization:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **Shareholder** | **Investment** | **Price/Share** | **No Shares** | **Ownership** |
| Series B | $18m | $3 | 6m | 30% |
| Series A | $5m | $1 | 5m | 25% |
| Ordinary |  |  | 9m | 45% |
| Total |  |  | 20m | 100% |

Techco was acquired 2 years post Series B for $98m. Payout:

|  |  |  |  |
| --- | --- | --- | --- |
| **Shareholder** | **Liquidation Pref** | **As Converted to Common** | **Exit Returns** |
| Series B | $18m | $24m | $42m |
| Series A |  | $20m | $20m |
| Ordinary |  | $36m | $36m |
| Total | $18m | $80m | $98m |

Series B shareholders will receive their liquidation preference of $18m and also receive a share of the remaining proceeds on an as converted to ordinary basis (30% of $80m) amounting to $24m for a total exit return of $42m. Series A shareholders will choose to convert their shares to Ordinary and receive (25% of $80m) $20m. Ordinary shareholders will receive the remaining $36m.

**Ordinary Shares (also known as Common Stock):** Ordinary Shares are typically issued to founders, management, and employees. Ordinary shareholders rank below debt holders and preferred shareholders in terms of liquidation preference and dividends and are not entitled to preferential rights accorded to holders of Preferred Stock.

**Preference Shares/Preferred Stock:** Preferred Shareholdersare entitled to certain preferential rights (such as preferential access to dividends, liquidation preference, anti-dilution protection etc.) over and above ordinary shareholders. These rights are subjects for negotiation and stipulated in the Term Sheet and ensuing legal documents such as the Shareholders’ Agreement and/or constitutional documents. Unlike preference shares in public companies, preference shares in private companies (typically held by venture capital funds) are convertible to ordinary shares and come with voting rights and may even include seats on the Board.

**Pre-money Valuation:** The value of the company immediately before the current round of investment.

**Post-money Valuation:** The value of the company immediately after the current round of investment.

* Post-money Value = Pre-money Value + Investment into Newly Issued Shares

**Redemption Right:** Depending on negotiation, preference shares may come with the right to sell the shares back to the company usually after a specified period (typically more than 3 years) at the original purchase price plus all accrued but unpaid dividends and/or plus a specified rate of return. Typically a redemption right is a right of a shareholder to redeem their preferences shares but there may be instances (negotiated and set out in the Shareholders’ Agreement or constitutional documents) where the right to redeem is at the discretion of the board of directors.

**Reserved Matters or Protective Provisions:** Refer to certain key decisions that require the concurrence of (i) a predetermined percentage of minority shareholders or preferred shareholders voting either as a Series of Preferred shareholders (each voting as a class) or all Preferred shareholders voting together as a class or (ii) directors appointed by the holders of Preferred Stock(if applicable). The percentage of minority shareholders or preferred shareholders that must agree is subject to negotiation and can vary for each Series or company.

* **Key decisions included under Protective Provisions can vary and often include but are not limited to :**

1. A sale of the company or other “Liquidation Event”
2. Any amendment to the company’s Certificate of Incorporation that alters or changes the powers, preferences or special rights of Preferred Shareholders
3. Any increase or decrease (other than by conversion) in the total number of authorized shares (Preferred or Ordinary)
4. The authorization or issuance of any equity security having a preference over, or being on a parity with, any series of Preferred Stock with respect to dividends, liquidation or redemption
5. The redemption or purchase of Preference or Ordinary Shares (subject to certain exceptions)
6. Any declaration or payment of any dividends or any other distribution on account of any Preference or Ordinary Shares
7. Any change in the authorized number of directors of the company
8. Any hiring, firing or change in the compensation of any key executive officers of the company.

**Pre-Emption Rights over New Issuances:** A contractual right of Preferred Shareholders (or, if negotiated and agreed, all shareholders) to purchase new issuance of shares in subsequent rounds of financing on a pro-rata basis.

**Right of First Refusal:** In the event of a sale of shares by an existing shareholder to a third party, other shareholders may exercise their right of first refusal by matching the price offered by that third party. If matched, the seller is then bound to sell the shares to the other shareholders on a pro-rata basis.

**Right of First Offer:** Similar to a Right of First Refusal (see above) with the difference being that if a shareholder wishes to sell its shares to a third party, it must first offer those shares to the other existing shareholders. If any existing shareholders offer to buy the shares, then the selling shareholder must either sell its shares to those shareholders, or, to a third party at a higher price (and/or on less favourable terms). The selling Shareholder cannot sell its shares at the same or lesser price (as that offered by the existing shareholders) to a third party for a fixed period of time (to be negotiated and agreed in the Shareholders’ Agreement or constitutional documents of the company).

**Series A:** First round of financing led by a venture capital or institutional investor. The shares issued would be Series A Preference Shares, hence the name Series A round. Typically the company would be in the product design and development stage.Successive rounds of funding are then termed Series B, Series C and so forth.

**Tag-Along Right (also known as co-sale rights):** Refers to the right of preferred shareholders (or, if negotiated and agreed, all shareholders) to sell their shares alongside the Founders and/or other shareholders (owning more than a specified percentage of the company) on a basis proportionate to the amount of securities held by the seller and those held by the participating shareholders.It should be noted that Founders/Key Managers are often subject to a lock-up or restriction on the sale of some or all of their shares.

**Warranty:** A warranty is a contractual assurance from a seller to a buyer.  Depending on the agreement, warranties can cover a wide range of matters including but not limited to ownership of shares, licenses and intellectual property, validity of financial reports, quality and performance of products and compliance of employment regulations. A party that breaches a warranty is responsible for the loss and damage that is foreseeable as a result of the breach.