

Equity Financing Lexicon

Margaret D. Farrell, Esq.
Hinckley, Allen & Snyder LLP
50 Kennedy Plaza, Suite 1500
Providence, RI 02903
401-274-2000

Pre-Money Valuation

- The valuation of a company immediately before investors put new funding into the company. Used as the basis for calculating the investors' price per share and equity for new investment.
 - Example: \$4 million Pre-Money valuation results in a \$4 million investment for 50% equity
 - Consider impact of Option Pool on founder's share of equity

Preferred Stock

- Stock that has a “preference” over common stock, including priority in receipt of dividends and upon liquidation. Often has redemption rights, preferential voting rights and rights of conversion into common stock. Venture capital investments generally made in form of convertible preferred stock.

Preferential Dividends

- Cumulative Dividend:
 - A dividend that accumulates if not paid in period when due and must be paid before other dividends are paid on more junior stock (e.g., common stock). Also, often must be paid as part of liquidation preference.
- Arrearage:
 - Unpaid dividends due holders of cumulative preferred stock.
- Adjustable Rate Preferred:
 - Preferred stock whose dividends rate changes periodically based upon changes in a reference interest rate.
- Payment in Kind (PIK)
 - A feature permitting the issuer to pay dividends (or interest) in form of additional securities of same class (e.g. preferred stock dividends on preferred stock).

Liquidation Preference

- A right typically attached to preferred stock under which, upon liquidation, holders of preferred stock receive payment of a specified amount, typically at least equal to the initial investment amount, in prior over payments to other stockholders.
 - In venture capital financing, “liquidation” is generally defined to include a sale or holders of preferred stock have the option to treat a “sale” as a “liquidation”.
 - “Participating Preferred” is preferred stock that entitles holder not only to stated dividend and liquidation preference, but also to participate in dividends and liquidating distributions declared on common stock. Also called “Double Dip”.
 - “Multiple Preference”: when an investor receives a multiple of the original investment upon an exit or liquidation, such as a liquidation preference of two or three times the original issue price of the security.

Redemption Right

- Right to require company to repurchase its securities from an investor, often required by venture capitalists.
 - Legal restrictions on company's ability to redeem/repurchase shares can result in forced sale of company.

Voting Rights

- Generally on “as converted” basis
- Usually special voting rights/effective veto
 - Change in capitalization
 - Mergers, sales and acquisitions
 - Capital expenditures
 - Significant borrowings
 - Other major decisions

Conversion Ratio

- The ratio indicating the number of underlying securities that can be acquired upon exchange of a convertible security (e.g. shares of common stock upon conversion/exchange of preferred stock).

Dilution

- Ownership Dilution: A decrease in percentage ownership interest as a result of issuance of additional securities.
- Value Dilution: A decrease in the value of securities as a result of issuing or potential issuing of additional securities.

Investor Anti-Dilution Provisions

- Provisions in option or security which protect the holder's investment from dilution as the result of later issues of securities at a lower price than the investor paid by adjusting the conversion ratio.
 - Allowance is usually made for some degree of dilution as a consequence of issuance of options to employees under stock options plans.

Weighted Average Anti-Dilution

- Anti-dilution provisions that apply a weighted average formula to adjust the option price or conversion ratio of an early round investor, based on the sale price and number of common equivalent shares sold by the company after the issuing of the option or convertible security.
 - Example: If a first round of financing raised \$1 million of capital at \$2.00 per share and the first round investors received weighted average anti-dilution protection, and a second round of financing was consummated for another \$1 million at \$1.00 per share, then the first round investors would have the right to convert their shares at a weighted average adjusted price of \$1.50 share.

Full Ratchet Anti-Dilution

- Anti-dilution provisions that apply the lowest sale price for any shares of common stock (or equivalents) sold by the company after the issuing of an option or convertible security with anti-dilution protection as the adjusted option price or conversion ratio.
 - Example: If a prior round of financing raised capital at \$2.00 per share with investors receiving full ratchet anti-dilution protection, and a subsequent round of financing was completed at \$1.00 per share, the prior round investors would have the right to convert their shares at the \$1.00 price, thereby doubling the number of shares they would receive.

Pre-emptive Right (Ownership Anti-dilution protection)

- The right of an investor to participate in a financing to the extent necessary to ensure that, if exercised, its percentage of ownership of the company's securities will remain the same after the financing as it was before.

Pay-to-Play

- A provision in venture financing documents that states that if one of the venture investors declines to participate in a later financing round up to its pro rata ownership share of the company, it will forfeit certain of the beneficial terms of its investment, such as anti-dilution protection, pre-emptive rights, etc.

Potential Ownership Dilution for Founders

- Option pool, particularly if allocated to pre-money valuation
- Cumulative dividends, particularly if factored into conversion ratio, voting rights and/or liquidation preference
- PIK dividends, have effect of increasing investors' percentage ownership
- Vesting of founder stock

Vesting

- Time at which a right to purchase or retain stock becomes unconditional.
 - Over time employee/founder earns rights in stock.
 - Restricted stock or options to purchase stock that may not be sold or exercised, or that are subject to risk of forfeiture for a period of time are “unvested”.
 - Portion of stock that is not subject to risk of forfeiture and may be sold, or options that may be “exercised”, are “vested”.

Investor's Contractual Rights

- Information Rights
- Governance/Voting Rights
- Rights of First Refusal
- Tag-Along Rights
- Drag-Along Rights
- Registration Rights

Information Rights

- The contractual right to obtain information about a company, including, for example, attending board meetings. Typically received by venture capitalists investing in privately held companies.

Governance/Voting Rights

- Voting/Approval Rights
 - Requirement to obtain approval of certain class of investors or their designated directors for certain transactions, such as:
 - Pay dividends
 - Repurchase or redeem stock
 - Related party transactions
 - Adopt operating and capital budgets
 - Incur indebtedness in excess of specified amounts
 - Mortgage property
 - Capital expenditures in excess of specified amount or budget
 - Change size of board
- Board Composition:
 - Right to designate a specified number of directors
 - May also have approval right with respect to directors nominated by founders

Repurchase Agreement

- An agreement in which a stockholder agrees that the person from whom it purchased the securities may repurchase them in certain events. In venture capital rounds, founders may be required to enter into repurchase agreements in which they agree to resell their shares to the company at a fixed price in the event that they leave the company prior to a given date.

Right of First Refusal

- A contractual right, frequently granted to venture capitalists, to purchase shares held by other shareholders before such shares may be sold to a third party.

Tag-Along Agreement

- A contractual agreement by management stockholders, typically in connection with a venture capital investment, that they will not sell any of their stock in the company without giving the investors the right to participate in the sale with the management sellers *pro rata* to their holdings. Also called “Co-Sale Agreement”.

Bring-Along Rights

- Contractual rights pursuant to which minority shareholders are required to sell their securities in connection with a sale by the majority shareholders. Also known as “drag-along rights.”
 - Venture capitalists often have drag-along rights, entitling them to force the purchase of their shares by the founders or the sale of the company.
 - Such rights typically apply in connection with an acquisition transaction such as a sale of all the shares of stock or a sale of all or substantially all the assets of a company.

Initial Public Offering (IPO)

- The registered public offering of securities of an issuer to the public for the first time.
- IPO Participation Rights:
 - Rights sometimes negotiated by investors during periods when public markets are strong, entitling the investors to be allotted a portion of the stock to be sold to the public in an IPO.

Registration Rights

- The contractual right of a stockholder to participate in the registration of the issuer's stock for resale in the public market.
- Registration:
 - The process of filing the necessary documentation with the appropriate authorities for an offering of securities to the public, and having this registration approved or declared effective. In the USA, the registration statement is filed with the SEC, which also declares it effective.
- Registration Statement:
 - The document required by the Securities Act of 1933 to be filed with the SEC by the issuer of securities before a public offering can be made. A Form S-1, the most complete version, is required for initial public offerings.

Registration Rights

- **Demand Registration:**
 - The contractual right of a security holder to require an issuer to file a registration statement to register the holder's securities so that the holder may sell them in the public market without restriction.
- **Form S-3 Registration:**
 - Short version registration statement, used for public companies already registered under the Securities Exchange Act of 1934 that meet certain conditions. Usually required by investors in a venture capital financing.
- **Piggyback Registration:**
 - Contractual rights granted to security holders, giving them the right to have their holdings included in a registration statement if and when the issuer files a registration statement.

Margaret D. Farrell, Esq.



- **Margaret D. Farrell** is a Partner with Hinckley, Allen & Snyder LLP and Chairs the firm's Securities Practice Group. Her practice is concentrated in the area of corporate and securities law with extensive experience in organization, mergers and acquisitions, recapitalizations and other reorganizations of both public and privately-held corporations, partnerships and limited liabilities companies, and in personal and business tax planning. She has extensive experience in handling equity and debt securities offerings, both fully registered public offerings and exempt private placements and venture capital financings as well as ongoing SEC regulatory compliance and reporting. She received her B.A., *cum laude*, from Smith College and her J.D. from the University of Cincinnati, where she was a member of Order of the Coif and Note Editor of the Law Review. She is currently listed in Woodward/White Inc.'s *Best Lawyers in America* and Chambers & Partners' *USA Guide to America's Leading Lawyers for Business*.

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