I. VENTURE CAPITAL DEAL TALK

People often accuse lawyers of using too many words. I recently accepted a challenge to summarize the primary terms of a venture capital investment deal in 100 words or less. Here goes:

> $200,000 10% bridge loan with 25% warrant coverage. 20% of the company on a fully diluted basis for $2 million. $8 million pre-money valuation and $10 million post-money. Redeemable participating preferred stock with 5% cumulative dividend. Convertible into Common Stock. Qualified IPO triggers mandatory conversion. Weighted average price antidilution protection with 15% option pool. Investors receive first refusal and come along rights with overallotment options, drag along and visitation rights, as well one demand and unlimited piggybacks (cut backs pro rata) and S-3 registration rights.
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> There. That was simple and concise.
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> What do you mean, "what does it mean?"
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> "It's all in the definitions." Here are a few to explain our deal:

- **Antidilution Protection.** A provision that increases the number of shares of Common Stock issuable upon conversion of a convertible security or upon exercise of a warrant or option upon the occurrence of specified events, usually the issuance of more shares for a low price.

- **Bridge Financing**. A loan is used to provide the company with operating capital while the investors conduct due diligence and negotiate the terms of the investment. The bridge loan is usually converted into equity at the next equity financing of the company.

- **Come Along Rights**. Sometimes also called Tag Along Rights. The right of an investor to sell shares, if a founder or other key employee sells shares. This right is designed to protect the investors against being trapped in an investment after the founders have cashed out.

- **Conversion Rate or Ratio**. Means the number of shares of Common Stock into which each share of Preferred Stock is convertible.

- **Convertible**. The right of the investor to convert shares of Preferred Stock into shares of Common Stock at the Conversion Rate stated in the corporate charter. Conversion is usually automatic upon the occurrence of a Qualified IPO. Mandatory conversion is necessary because companies sell Common Stock in their IPOs and new investors are not likely to purchase Common Stock, if earlier investors retain Preferred Stock with superior rights.

- **Covenant**. The obligation in a contact to do something. An obligation to refrain from doing something is called a Negative Covenant. For example, the obligation to obtain life insurance on key employees is a covenant and the obligation to not deviate from the budget approved by investors is a negative covenant.

- **Cumulative Dividend**. If the dividend is not declared during the period stated in the corporate charter, the dividend accrues and is payable in a later period. If a dividend right isn't cumulative, the dividend would be lost forever if it's not declared during the period stated in the corporate charter. Accrued but unpaid dividends are sometimes convertible into shares of Common Stock.

- **Cutback Rights**. Where shareholders exercise piggyback registration rights, but there are too many shares for the underwriters to sell in the public offering without adversely affecting the price, cutback rights determine whose shares are left out of the offering and whose shares are included in the offering.

- **Demand Registration Rights**. The right of investors to require the company to register the investors' shares for sale to the public even if the company was not otherwise planning to conduct a public offering. Usually, an investor or group of investors receives one or two Demand Registration Rights. Typically, the right isn't exercisable until after the company's initial public offering or after a stated time period.

- **Drag Along Rights.** The right of the owners of a specified percentage of the shares of the company to require other shareholders to sell their shares or to vote their shares to approve sale of the company. This prevents one group of shareholders from blocking sale of the company to someone who is only interested in purchasing 100% ownership of the company.

- **Fiduciary.** Someone who owes special duties to another person and who has liability for not performing that duty.

- **First Refusal Rights.** The right to purchase stock in future offerings by the company on the same terms as other investors. Usually the right is designed to enable investors to maintain their percentage ownership of the company by purchasing a pro rata share of all new stock sold by the company. Investors also often require company founders to grant first refusal rights on shares the founders own. Also sometimes called Preemptive Rights.

- **Full Ratchet.** A type of Antidilution Protection that adjusts the Conversion Ratio so that each share of Preferred Stock will be convertible into a number of shares of Common Stock equal to the number of shares the investor would have received, if the investor had purchased the shares at the lowest subsequent price at which the company later sells its stock. The number of shares sold at the lower price doesn't matter. Only the lower price matters. For example, if the company sells Preferred Stock with a one-for-one Conversion Ratio for $10 per share and later sells Common Stock for $1 per share, each share of Preferred Stock would become convertible into ten shares of Common Stock, even if only one share is sold at the lower price.

- **Fully Diluted.** Fully diluted means the total number of shares of Common Stock the company has issued, plus all shares of Common Stock issuable if all outstanding options, warrants, convertible preferred stock and convertible debt were to be exercised or converted. Fully diluted calculations are used to compare the percentage ownership of a company of different classes of securities by reducing each class to its Common Stock equivalent.

- **Information Rights.** The right of investors to have the company provide financial information annually, quarterly or monthly and other information as requested by investors.

- **Key Man Insurance.** Insurance on the life of key employees which investors require the company to obtain.

- **Lead Investor.** The investor who takes on most of the work in negotiating the investment terms, doing due diligence and monitoring the company after the closing. The lead investor usually invests more than other investors who participate in the round. The lead investor is often located near the company or specializes in the company's industry.

- **Milestone.** An event that triggers another investment by the venture investors.

- **Option Pool.** A number of shares of Common Stock specified in the corporate charter that can be sold to employees, officers and directors at low prices without triggering the Price Antidilution Protection of the Preferred Stock. 15% of the fully diluted shares is fairly typical, although the size of the Option Pool usually depends on the number of shares estimated to be necessary to grant to employees to attract a team capable of achieving the goals of the company's business plan. This varies from one company to another. Option Pool shares are usually considered to be outstanding shares when calculating the company's valuation.

- **Overallotment Option.** The right of investors to exercise the First Refusal Rights and Come Along Rights of other investors who don't exercise their own rights.

- **Participating Preferred Stock.** A class of stock with a Liquidation Preference, whereby on liquidation, sale or merger of the company, the owner has the right to share on an equal basis with holders of Common Stock any money or other assets that remain for distribution after payment of the Liquidation Preference of the Preferred Stock. With Nonparticipating Preferred Stock, the holders of Preferred Stock must choose either to receive their Liquidation Preference or to receive the same distribution holders of Common Stock receive. A holder of Participating Preferred Stock doesn't have to choose and receives both.

- **Piggyback Registration Rights.** The right of investors to have shares included in a public offering the company plans to conduct for itself or another shareholder. Usually, this applies to an unlimited number of offerings until the registration rights terminate.

- **Post-Money Valuation.** Calculated by adding the dollar amount invested in the transaction to the Pre-Money Valuation.

- **Preemptive Rights.** Similar to rights of first refusal.

- **Preferred Stock.** A class of stock with a Liquidation Preference; that is, the right to receive distributions of money or assets prior to one or more other classes of stock if the company is sold, merged or liquidated. This protects investors by ensuring the investors get their money back (and sometimes a fixed return on the investment) before holders of Common Stock receive any money or assets.

- **Pre-Money Valuation.** The theoretical value of the company before the investment agreed upon by the company and the investors. Pre-Money Valuation is calculated by multiplying the number of Fully Diluted shares of the company before the investment transaction by the purchase price per share in the investment transaction.

- **Price Antidilution Protection.** Protects investors from overpaying for stock by adjusting the Conversion Ratio if the company later issues shares for a price less than the price the investors paid. Adjustment of the Conversion Ratio results in more shares of Common Stock becoming issuable upon conversion of each share of Preferred Stock than was agreed at the time of the investment. There are two basic types of Price Antidilution Protection; Full Ratchet and Weighted Average. Weighted Average can be either Broad Based or Narrow Based.

- **Protective Provisions.** The right of an investor or group of investors to veto certain transactions by the company. This is usually achieved by prohibiting certain transactions, unless they are approved by a class vote of the Preferred Stock.

- **Qualified IPO.** Means an initial public offering by the company of a size and price specified in the corporate charter. An IPO with $20 million in gross proceeds to the company and a price per share three times the price the investor paid for its stock is fairly typical for a Qualified IPO, but this varies from one deal to another.

- **Play or Pay.** A provision which penalizes investors who fail to purchase their pro rata share of securities in a later investment round.

- **Redeemable.** The right of the investor to require the company to repurchase the investor's stock for a price specified in the corporate charter. Redemption rights usually are not exercisable until five years or longer after the investment. Redemption rights are rarely exercised, but they give investors leverage to ensure their investment will eventually become liquid through sale of the company if an IPO hasn't occurred by a specified date.

- **Registration Rights.** The right of investors in a public offering to require the company to include shares owned by the investors in a registration statement filed with the Securities and Exchange Commission under Section 5 of the Securities Act of 1933. There are three general types of registration rights (i) Demand; (ii) Piggybacks; and (iii) S-3.

- **S-3 Registration Rights.** The right of investors to require the company to file a short form registration statement on Form S-3. S-3 Registration Rights are similar to Demand Registration Rights, but usually one or two registrations each year are permitted, because the short Form S-3 is less burdensome to the company.

- **Syndicate.** The group of venture investors who participate in the investment round.

- **Visitation Rights.** Also called Observer Rights. The right of investors to have a nonvoting representative attend meetings of the Board of Directors of the company and committees of the Board.

- **Warrant.** The right to purchase stock at a later date at a fixed price. Similar to stock options, but usually given to investors, not employees.

- **Warrant Coverage.** Warrants issued to reward bridge loan lenders, guarantors or other lenders for incurring the risk of lending. The number of shares issuable upon exercise of the warrants is based on a percentage of the debt.

- **Weighted Average.** A form of Antidilution Protection that adjusts the Conversion Ratio according to a formula that takes into account both the lower price and the number of shares issued at the lower price. This is more favorable to the company than a Full Ratchet. Narrow Based Weighted Average uses only the number of outstanding shares of Preferred Stock in the formula used to adjust the conversion price. This is more favorable to the investor than Broad Based Weighted Average, which includes all fully diluted shares in its formula.