Everything You Ever Wanted to Know About Venture Capital Financing Terms

# Venture Capital Basics

*Part Three of Three*

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Editor's Note: This is Part Three of a three-part series by Marc Porter on basic venture capital financing terms. In Part One, Marc discussed the concepts of pre-money value, liquidation preference and drag along rights. In Part Two, Marc discussed liquidity through a public offering, sale to the company and co-sale rights. Marc also addressed the issues of voting and control. In Part Three, Marc will discuss various terms designed to protect an investor against dilution of its investment. All three sections may be read online at http://www.connect-utah.com/article.asp?r=221.

## Anti-Dilution Protection

A company will often require several rounds of financing, involving multiple investors, to achieve profitability. Each new equity financing dilutes the ownership of earlier investors. What's more, "down round" financings (defined as a round of financing for which a company's pre-money value is less than its post-money value after the prior round of financing) are especially dilutive and are a common occurrence in today's economy. The impact of a down round financing on an existing investor can be significant.

For the sake of simplicity, all of the examples in this article assume that the company has issued all authorized options. Most often, a company will have reserved some options for issuance in the future. An investor will often include the entire option pool (both issued and unissued options) in the pre-money calculation.

Example

- Outstanding capital: 10,000,000 common shares and options
- Pre-money value: $10 million
- Per share value of outstanding capital: $1.00
- Investment amount by Fund A: $5 million
- Number of preferred shares issued to Fund A: 5,000,000 ($5 million/$1.00)
- Post-money value: $15 million
- Post-money outstanding capital: 15,000,000 shares and options (10,000,000 common shares and options and 5,000,000 preferred shares)

With its $5 million investment, Fund A owns 5,000,000 of the 15,000,000 shares and options outstanding, or 33.33% of the company. The holders of common shares and options together own 66.66% of the company. Two years later, the company needs additional funding. Due to lackluster sales, competition and other factors, the company's pre-money value is $7.5 million.

- Pre-money value: $7.5 million
- Per share value of outstanding capital: $0.50 ($7.5 million/15,000,000)
- Investment amount by Fund B: $5 million
- Number of preferred shares issued to Fund B: 10,000,000 ($5 million/$0.50)
- Post-money value: $12.5 million ($7.5 million + $5 million)
- Post-money outstanding capital: 25,000,000 shares and options

As a result of its $5 million investment, Fund B holds 10,000,000 of the 25,000,000 shares and options, or 40% of the company. For its $5 million investment, Fund A holds only 5,000,000 of the 25,000,000 shares and options outstanding, or 20% of the company. What's more, Fund A's investment is now only worth $2.5 million, or half of its original value.

An investor will attempt to protect itself against dilution of the type suffered by Fund A by (1) negotiating an anti-dilution adjustment to its shares in a dilutive event (such as the above down round financing) and (2) negotiating the right to purchase shares issued by the company in future financing rounds. These rights are typically not extended to the founders and other holders of the company's common shares.

## Anti-Dilution Adjustment

A holder of preferred shares may convert the shares into common shares at any time. The number of shares into which a preferred share is convertible is determined by the then applicable conversion ratio. The conversion ratio is typically a fraction. The numerator is the original purchase price of the preferred shares and never changes. The denominator (or "Conversion Price") typically starts out being equal to the original purchase price of the shares (making the preferred shares initially convertible into an equal number of common shares), but is adjustable for stock splits, stock dividends, stock combinations and other recapitalizations that affect the number of common shares into which the preferred shares are convertible. To avoid the dilution suffered by Fund A in the above example, an investor may also insist that the Conversion Price be adjusted in a dilutive event such as a down round

financing or other issuance of shares at a price per share less than that paid by the investor. This anti-dilution adjustment will be on one of the following three bases:

- "full ratchet;"
- "narrow-based weighted average;" or
- "broad-based weighted average."

## Full-Ratchet Adjustment

Full ratchet adjustment provides the greatest anti-dilution protection for an investor (and has the most draconian impact on the company's other shareholders) because the investor is treated as if it purchased its shares at the price paid (or deemed to be paid) in the dilutive event. This adjustment is effected by changing the Conversion Price for the shares to the price per share paid in the dilutive event. Full ratchet adjustment does not take into account the number of shares purchased in the dilutive financing. In other words, the adjustment mechanism is triggered even if the company issues only one share at a price per share less than the shares entitled to full ratchet adjustment. Furthermore, a full ratchet adjustment gives an investor no incentive to participate in the new round of financing.

Example: Full-Ratchet Adjustment

- Investment amount by Fund A: $5 million
- Price per share: $1.00
- Number of preferred shares received by investor: 5,000,000 ($5 million/$1.00)
- Anti-dilution protection: full-ratchet
- Post-money value: $15 million
- Post-money outstanding capital: 15,000,000 shares and options (10,000,000 common shares and options and 5,000,000 preferred shares).

As a result of its $5 million investment, Fund A holds 5,000,000 of the 15,000,000 shares and options outstanding, or 33.33% of the company. The holders of the common shares and options (the "Common Holders") together hold 10,000,000 of the 15,000,000 shares and share equivalents outstanding, or 66.66% of the company. Two years later, the company is in need of additional capital and due to lackluster sales, the company's pre-money value is $7.5 million.

- Pre-money value: $7.5 million.
- Per share value of outstanding capital: $0.50 ($7.5 million/15,000,000)
- Amount invested by Fund B: $5 million
- Full-ratchet adjustment to Conversion Price for Fund A's preferred shares: $1.00 to $0.50
- Number of common shares into which Fund A's preferred shares are convertible: 10,000,000 (based on the formula 5,000,000 * 1/0.50)
- Post-money value: $12.5 million
- Post-money outstanding capital: 30,000,000 shares and share equivalents (the 15,000,000 shares and options outstanding prior to Fund B's investment, the additional 5,000,000 common shares into which Fund A's preferred shares are convertible and the 10,000,000 preferred shares purchased by Fund B)

As a result of its $5 million investment, Fund B holds 10,000,000 of the 30,000,000 shares and options, or 33.33% of the company. Fund A's preferred shares are now convertible into an additional 5,000,000 common shares and thus Fund A retains its 33.33% ownership. The Common Holders hold 10,000,000 shares and options outstanding, or 33.33% of the company. The Common Holders' ownership has been reduced from 66.66% to 33.33%.

As this example illustrates, full ratchet adjustment protects Fund A completely against the dilutive effect of Fund B's investment. This means that (1) Fund B is able to purchase less of the company than it would have had Fund A not been protected against dilution (and, in fact, Fund B may elect not to participate in the financing if Fund A is unwilling to renegotiate its position) and (2) without the benefit of anti-dilution protection, the Common Holders bear all of the impact of the dilutive event.

A company will resist giving an investor full ratchet protection because it may, if triggered, require the founders and other holders of common shares to bear all of the impact of a dilutive event. It will also argue against full ratchet protection on the basis that it does not take into account the number of shares issued in the dilutive event. Finally, a company will resist full ratchet protection because it makes the company less attractive to new investors. Depending on its leverage, an investor may insist on the provision, arguing that it can always waive adjustment in the future if circumstances warrant.

If a company gives an investor full ratchet protection, the company may propose that the full ratchet protection be replaced with narrow- or broad-based weighted average protection upon the company's achievement of time-based milestones (typically eighteen months to two years) or performance-based milestones (such as achieving certain levels of revenue or successfully beta testing the company's core technology). The company may also insist that an investor "pay to play" in any anti-dilution adjustment in the future by conditioning the adjustment on the investor's purchase of shares issued in the dilutive event. The degree of participation upon which the anti-dilution adjustment is conditioned is typically determined with reference to the investor's pro rata participation rights under its right of first offer (or pre-emptive right) discussed below. An investor who does not "play" by purchasing at least its pro rata allocation of the newly issued shares, "pays" by losing, among other things, anti-dilution protection for its existing shares.

Depending on the particular pay-to-play provision, an investor may also lose its liquidation preferences and other rights associated with its preferred shares.

## Narrow-Based Weighted Average Adjustment

Unlike full-ratchet adjustment, narrow-based weighted average adjustment takes into account (1) the number of shares issued in the dilutive financing, (2) the consideration paid for such shares and (3) either the total number of common shares or all voting shares outstanding.

Under the narrow-based weighted average conversion formula, the Conversion Price is multiplied by the quotient obtained by dividing (1) the total number of common shares outstanding (or the total number of voting shares outstanding) plus the aggregate consideration received by the company for the new shares issued in the dilutive financing by (2) the total number of common shares outstanding (or the total number of voting shares outstanding) plus the total number of new shares issued in the dilutive financing.

Example: Narrow-Based Weighted Average Adjustment (Based on Total Number of Common Shares Outstanding)

- Same facts as the full-ratchet adjustment example, except that Fund A is entitled only to narrow-based weighted average adjustment.
- Narrow-based weighted average adjustment to Conversion Price for Fund A's preferred shares: $1.00 to $0.66 per share
- Number of common shares into which the preferred shares are convertible: 7,500,000 (based on the formula 5,000,000 * 1/0.66).
- Post-money value: $12.5 million
- Post-money outstanding capital: 27,500,000 shares and options outstanding (the 15,000,000 shares and options outstanding prior to Fund B's investment, the additional 2,500,000 common shares into which Fund A's preferred shares are convertible and the 10,000,000 preferred shares purchased by Fund B).

As a result of its investment, Fund B holds 10,000,000 of the 27,500,000 shares and options outstanding, or 36.36% of the company. Fund A holds 7,500,000 shares and options outstanding, or 27.27% of the company and the Common Holders hold 10,000,000 shares and options outstanding, or 36.36% of the Company.

As this example illustrates, a narrow-based weighted average adjustment provides only partial protection

against dilution. As a result, Fund A owns approximately 6% less of the company that it would have owned with full-ratchet protection. Without the benefit of anti-dilution protection, the Common Holders still bear most of the impact of the dilutive financing, but retain a slightly higher percentage of the company than they do in a full-ratchet adjustment scenario.

## Broad-Based Weighted Average Adjustment

Of the three types of anti-dilution adjustment, broad-based weighted average adjustment provides the least amount of anti-dilution protection because it takes into account not only number of shares issued in the dilutive financing and the total number of common shares (or all voting shares) outstanding, but also the total number of all common share equivalents (e.g., options, warrants, preferred shares) outstanding. As a result, this adjustment is favored by founders and other holders of common shares.

Under the broad-based weighted average adjustment formula, the Conversion Price is multiplied by the quotient obtained by dividing (1) the total number of common shares and common share equivalents outstanding plus the aggregate consideration received by the company for the new shares issued in the dilutive financing by (2) the total number of common shares and common share equivalents outstanding plus the total number of new shares issued in the dilutive financing.

Example: Broad-Based Weighted Average Adjustment (Based on Total Number of Common Shares Outstanding)

- Same facts as in the full ratchet adjustment example, except that Fund A is entitled only to broad-based weighted average adjustment.
- Broad-based weighted average adjustment to Conversion Price for Fund A's preferred shares: $1.00 per share to $0.80 per share.
- Number of common shares into which the preferred shares are convertible: 6,250,000 (based on the formula 5,000,000 * 1/0.80).
- Post-money value: $12.5 million
- Post-money outstanding capital: 26,250,000 shares and options outstanding (the 15,000,000 shares and options outstanding prior to Fund B's investment, the additional 1,250,000 common shares into which Fund A's preferred shares are convertible and the 10,000,000 preferred shares purchased by Fund B).

As a result of its $5 million investment, Fund B holds 10,000,000 of the 26,250,000 shares and share equivalents, or 38.10% of the company. Fund A holds 6,250,000 shares and share equivalents, or 23.81% of the company and the Common Holders hold 10,000,000 shares, or 38.10% of the company.

## Exemptions

A company will want to exempt, or "carve out," certain issuances of shares from any anti-dilution adjustment. Standard exemptions include:

- options or warrants issued under equity incentive plans;
- common shares issued upon conversion of the preferred shares;
- dividends issued on the preferred shares or common shares;
- shares issued in connection with stock splits and
- shares issued in connection with a merger, consolidation or acquisition.

Additional exemptions often include shares that are issued for a purpose other than raising capital and therefore may not necessarily reflect the current fair market value of the company's shares. Such exemptions include issuances in connection with:

- partnerships;
- joint venture arrangements;
- strategic investments;
- equipment leases and
- commercial borrowing.

An investor may agree to some or all of these carve outs or may propose a middle ground requiring that such issuances be approved by a majority of the directors or the directors appointed by the investor.

No matter the number of carve outs, the company should insist on an "on/off switch" that allows the holders of a majority or some higher percentage of the preferred shares to exempt a particular issuance not otherwise exempt from anti-dilution adjustment. This provision is critical because it allows preferred shareholders to waive anti-dilution protection without having to obtain the unanimous approval of the preferred shareholders or amend the company's charter. A company will also want to ensure that the anti-dilution provision is drafted so that adjustment is not triggered by the issuance or deemed issuance of additional shares in connection with any anti-dilution adjustment.

## Right of First Offer (Pre-emptive Right)

Most investors in today's market will also attempt to protect against dilution by negotiating a right of first offer (or "pre-emptive" right). With this right, an investor is entitled to purchase its pro rata allocation of any shares the company issues in the future. The pro rata allocation may be based upon the investor's relative ownership of the fully diluted capital, the voting shares or the preferred shares of the company. If there is a pay-to-play provision, the company may attempt to raise the stakes by negotiating for a pro rata allocation based on relative ownership of the preferred shares. In the absence of such a provision, the company may push for a pro rata calculation based on its fully diluted capital so as to give the company the flexibility to issue shares to new investors in later rounds of financing.

As with anti-dilution adjustments, a right of first offer will be subject to certain carve outs. These carve outs generally mirror the carve outs to the anti-dilution adjustment. An investor may insist that the on/off switches for anti-dilution adjustment and the right of first offer be mutually exclusive so that it retains the flexibility to waive anti-dilution adjustment without waiving its right to purchase additional shares under its right of first offer.

## Conclusion

This article, including parts one and two, only scratches the surface of the wide range of terms and issues that require careful consideration and negotiation in a venture capital transaction. A company must understand and be in a position to negotiate a host of other issues, which may include:

- the appropriate size of its option pool;
- the vesting and other terms of options granted to its employees in the past and in the future;
- which employees will be required to enter into a non-competition agreement;
- the hiring or firing of certain employees; and
- changes to the company's core business plan or products.

A lack of experience in venture capital transactions should not deter a company from pursuing a financing. A company can select legal counsel that is experienced in negotiating venture capital transactions for start-up and emerging growth companies on the one hand and venture funds on the other. Experienced legal counsel can help level the playing field between an inexperienced company and the more experienced venture fund. If necessary, a company can also turn to advisors who counsel start-up and emerging growth companies. fin

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