

A Plain English Guide to the Language of Capital

I. Introduction. Here are select investment terms. These are written in "plain English" rather than in technical legal form to aid your understanding.

II. Types of Companies.

"Corporation": two of the most significant aspects of corporations are limited liability and taxation. Limited liability means that if the corporation follows specified rules and principles, then the stockholder's maximum loss will be the amount of its investment in the corporation. While this loss can be significant, the stockholder's other personal assets (like house, car, bank accounts, etc.) will not be used to satisfy corporate liabilities.

For tax purposes, there are two types of corporations:

"C corporation" is a typical corporation. The most significant drawback of a C corporation is that its assets are subject to "double taxation," i.e., they are taxed once when the corporation earns the assets and a second time when those assets are distributed to its stockholders.

"S corporation" is a special corporation that does not have a corporate-level of taxation, thus avoiding the double tax. The most significant drawback to an S corporation is that corporations and limited partnerships cannot invest in them, thus precluding most angel and venture investors.

"Limited Liability Company" or **"LLC"**: this is a relatively new form of company that allows limited liability (like a corporation) but avoids the corporate-level of taxation (similar to an S corporation). Corporations and limited partnerships generally can invest in LLC's. Significant drawbacks are that they tend to be more complex and more expensive to operate than a corporation.

III. General Terms of Capital.

Angel and venture investments generally take two forms: either Preferred Stock or Subordinated Debt with Warrants.

"Capital" means the equity of the company and some types of debt (e.g., some subordinated debt) but generally not senior secured debt (like a bank loan).

"Equity" means the residual ownership in a company like a corporation or limited liability company. It may be either common or preferred. "Common Equity" is the first to absorb losses. It is also entitled to all the assets and cash of the company after the company pays its obligations like bank debt, subordinated debt, taxes, trade creditors, employee obligations, and preferred stock. As such, it enjoys the "upside" that debt does not.

"**Common Stock**" is the equity ownership in a corporation. It also has the basic voting rights of the corporation.

"**Preferred Stock**" is a type of equity ownership in a corporation. Preferred Stock is senior to common stock and junior to debt. Preferred Stock is a contract right; that is, its terms must be set forth clearly in writing in order to obtain anticipated benefits and burdens. Preferred Stock can have a variety of voting, dividend, management, conversion and other rights. It will be crafted carefully to allocate when the parties enjoy the upside while being protected from the downside.

"**Membership Interests**" are the equity ownership in a limited liability company. They may be either common or preferred. They generally have the basic voting rights of the LLC.

"**Subordinated Debt**" is a type of debt that is generally unsecured, is junior to senior debt (like a bank loan) and is senior to common stock and preferred stock. Angel or venture investors may make this form of investment. To allow the investor to have "upside" like Equity, the Subordinated Debt may be convertible into Equity (i.e., Convertible Debt) or the investor may be issued Warrants.

"**Warrants**" are a form of Equity similar to an option allowing the Warrantholder to exercise the Warrant and obtain equity (generally either Common Stock or Common Membership Interests). Generally, the Warrant must be exercised within a fixed period of time (say, 3-5 years) for a fixed price.

"**Senior Debt**" is the most senior form of debt and is usually secured by the assets of the company. It is generally the preferred investment by banks and asset-based lenders.

IV. Select Investment Terms.

It is assumed the investment is in the form of Preferred Stock in a C corporation rather than Common Stock or Subordinated Debt with Warrants, or Membership Interests in a LLC. There is an increasing trend to form growth companies as LLC's rather than C corporations or S corporations. Even when LLC's are used, the parties generally use "C corporation" terms to talk about the investments. Thus, they will say "preferred stock," "stock options" and "board of directors" when the technical LLC terms would be "preferred membership interests," "profits interests" and "board of managers." Irrespective of whether the actual company is an LLC or a corporation, the parties will need to be familiar with the technical terms of both.

"**Liquidation Preference**" means the amount to be paid when the company is liquidated or sold. Generally, it's the original price paid for the Preferred Stock plus Dividends. An investor may also get to share with the common stock if the investor has a "Participating Liquidation Preference."

- "Participating vs. Non-participating Liquidation Preference" is a distinction between Preferred Stock that can share (participate) with the common stock when the company is liquidated or sold and those that cannot share (non-participating). For example, if an investor has a Participating Liquidation Preference, when a company is liquidated or sold, the investor will get (1) its original investment, and (2) any Dividends it is owed. The investor receives (1) and (2) before common stockholders receive anything. It will also get (3) its pro rata share (along with the common stock) of any other cash or property left over. There may be caps on the investor's participation and there may be Management Carve-outs.

- "Super-charged Liquidation Preferences" have been prominent in post-Bubble financings: the investor may get 2, or 3, or more times its initial investment before common stock gets anything.

"Management Carve-outs".- as investors have gotten more aggressive in post-Bubble financings with Super-charged Liquidation Preferences, often-times there is nothing left for the common holders or management. Thus, if management is not incented, it will not cause the company to perform and grow. Recognizing this, investors will allow Management Carve-Outs to the investors' Super-charged Liquidation Preferences so that it is "worthwhile" for management to continue to run the company.

"Dividends" are cash, stock and other property paid by the company to the investor in the investor's capacity as a stockholder. Generally, dividends are discretionary with the company and aren't paid unless contracted for or long after the company's Initial Public Offering (IPO). Economically, dividends are similar to interest payments but are taxed differently.

- "Cumulative vs. Non-Cumulative Dividends" refers to whether a missed dividend payment continues to accrue. For example, assume the company fails to make a quarterly dividend payment to the investor. If the dividend is cumulative, the investor will still be owed it. If the dividend is not cumulative, the investor will not.
- "Participating vs. Non-Participating Dividends" is a distinction between dividends that can share (participate) with common stock and those that do not share (non-participating).

"Redemption Rights" are an investor's rights to force the company to purchase its shares (a "Put") and, less frequently, the company's right to force the investor to sell its shares (a "Call"). A Put allows the investor to liquidate its investment if it does not believe an IPO or public merger is likely or that some other milestone will occur. Usually the term for redemption (e.g., after three to five years) is fixed at the time of the investment. An investor may also have a Put if the company defaults or fails to make payments or upon a key employee's death, etc.

"Conversion Rights" are the rights by which the investor's Preferred Stock or Subordinated Debt "converts" into common stock. Usually, the investor will have this right to convert at any time after the initial investment. The company may want rights to force an "Automatic Conversion" upon an IPO or a Qualified IPO, a sale of the company, the hitting of certain sales or earnings targets, or a majority or supermajority vote of the Preferred Stock, etc. Conversion Rights will carry with them Anti-Dilution Protections.

"Anti-Dilution Protections" are the means by which an investor preserves its percentage ownership in the company without having to make a new investment. They are different from First Refusal Rights in that, with Anti-Dilution Protections, an investor does not have to pay in order to maintain its position. There are three basic types of Anti-Dilution Protection:

- "Typical." Provides for protection in the event of a stock split, stock dividend or similar recapitalization.

- "Full ratchet." Provides for complete preservation of the investor's percentage ownership in all circumstances even if only one share of stock is sold. It also includes protection in the event of a subsequent sale or merger. These have become more common in recent post-Bubble financings.
- "Modified ratchet." Provides for "ratcheting" in limited circumstances such as new subsequent offerings at prices lower than the investor's per share investment price (so-called "down rounds") or employee equity offerings beyond the agreed-to employee pool.

"**First Refusal Rights**" allow the investor to continue to maintain its ownership percentage in the company provided it pays the then-current stock offering price or some other negotiated price. First Refusal Rights typically only apply while the company is privately held. They generally provide that, before the company, the founder or other significant investors can sell shares to a third party, they have to offer them to the investor at either the sale price or a previously negotiated formula price.

"**Pay-to-play** ": this ambiguous term comes up in a variety of contexts. It may mean that the company wants to limit an investor's Anti-Dilution Protection and provide that the investor has to pay to maintain its percentage ownership. In this case, it is usually called "Pre-emptive Rights. " It may also mean that a subsequent investor forces a previous investor either to pay to maintain its percentage ownership or to forego its Anti-Dilution Protection and be automatically converted to common.

"**Most Favored Nations clauses**" is another term that has become popular in the post-Bubble financings. It generally means that Investor A gets the benefit of all subsequent financial and legal terms that are more favorable than the deal Investor A cut. In other words, if Investor A cuts a deal and later Investor B is able to cut a more favorable deal, then Investor A automatically gets the benefit of some or all of Investor B's terms.

"**Voting Rights**" are an investor's rights to vote for the board of directors and other important events like sales and mergers. Voting rights are usually divided along the following lines:

- Full voting rights. An investor votes with the common stock on each matter submitted to them as if its preferred shares had been converted into common.
- Class voting. In addition, the corporate statute or the company's certificate of incorporation may provide an investor with a class vote that allows the investor class of Preferred Stock to vote separately on matters such as sales or mergers. It may be that a particular class of Preferred Stock votes alone or that all classes of Preferred Stock vote together.
- Right to elect director(s). In addition, an investor may have a guaranteed right to elect one or more directors to the board. Upon an event of default or other "bad event," an investor may have the right to take over control of the board (the so-called right to "vault the board").
- Special voting rights. These may include "vetoes" over certain matters or supershare voting, e.g., 25-for-1 voting upon default.

"Restricted Stock": it is likely that the stock purchased from the company by the investor will be "restricted stock" under the securities laws because it was purchased in a "private placement." This means it will likely not be transferable until certain conditions of the securities laws are met.

Note: there are legal restrictions on the transfer of stock but there may be practical limitations too. If the stock is private, there may be no market for it. If the stock becomes public, there still may not be a market for it.

"Registration Rights" The Preferred Stock will likely be "Restricted Stock." Registration rights are a means by which an investor can sell its shares to the public in compliance with the securities laws, although the sale will likely be subject to Lock-up Agreements and Market Stand-off Agreements. Registration itself means registration with the Securities and Exchange Commission and, if necessary, each appropriate state securities commissioner. Registration is an expensive, time-consuming, burdensome process, the costs of which are typically borne by the company. Because of that, it is a highly negotiated portion of the investor's agreement.

There are several types of registration rights:

- Long-Form Demand Registration. This allows an investor to demand registration before the company becomes public. In essence, an investor can force public registration. This usually starts one to three years after the initial investment and may involve one or two demands for a percentage of the investor's stock (such as 50%). For this, the company will use the SEC's long-form registration (currently Form S-1).
- Short-Form Demand Registration. This demand can be made only after the company is publicly traded and is eligible to use the SEC's short-form registration (currently Form S-3).
- Piggyback Registration. This means that the company is registering stock either for itself or other stockholders and the investor is allowed to "piggyback" a portion of its shares for registration onto the company's registration. Usually an investor has these rights for up to five years after the company becomes public but the investor cannot exercise them for mergers or employee offerings. In addition, the investor may be subject to "cutbacks" at the discretion of the lead underwriter, which means that, even though the investor has registration rights, it cannot exercise some or all of them.

"Initial Public Offering" or "IPO" means the process by which the company becomes registered with the Securities and Exchange Commission and (hopefully) its common stock is listed on a national securities exchange (like the New York Stock Exchange) or quoted on Nasdaq. At that point, the company is a "public company."

"Qualified IPO" is an IPO that has met certain criteria. For example, the initial trading price of the common stock is at least \$6.00 per share, the net proceeds to the company is at least \$25.0 million and (in post-Bubble financings) the initial trading price is at least 5x or 10x the initial purchase price of the investor.

"Lock-up Agreements" are agreements entered into between the lead underwriter and significant stockholders of the company (including the investor) in which the stockholders agree not to sell any company stock for a certain period (often 180 days) after the company's IPO. This allows the market to absorb the company's offering. Although the 180 days is subject to negotiation with the underwriter, lately it's been fairly fixed.

"Market Stand-Off Agreements" are similar to Lock-up Agreements, and generally would prevent an investor from selling its company stock for 180 days after a previous public stock offering by the company. The 180-day requirement has more negotiation leeway here than in the Lock-up Agreement.

"Co-Sale Rights" are rights that allow an investor to "tag-along" in a sale by the founders and other significant stockholders. Usually an investor can sell a percentage of its shares up to its pro rata portion of all shares owned by the founder and other significant stockholders. An investor may also request "drag-along" rights if it owns enough of the company. With these rights, an investor can force the sale of the entire company in a deal it's negotiated.

"Information Rights" are rights granting the investor access to company information such as the right to inspect the company's books, "visitation" rights and the right to monthly, quarterly and annual financial statements, budgets and executive summaries.

"Covenants" are agreements by the company, usually financial or negative in nature, e.g., the company will maintain certain debt levels or will not pay management bonuses or excess compensation.

"Milestones" are generally specific company performance criteria that must be achieved before SOMETHING HAPPENS. That "something" is usually getting more money from the investor. For example, the investor may agree to invest \$1 million. A portion of that, say \$250,000, is invested initially and the balance is not invested until the company achieves a certain performance milestone like number of customers, certain revenue or profitability numbers, etc.

"Proxy": Often the investor will have the founder, an executive officer or even other major shareholders provide a proxy whereby the investor obtains their voting rights to securities in the company. The proxy may be exercised upon the death or disability of the founder/officer; it may also be used if there has been a default by the company or the founder/officer/shareholder.