START-UP LEGAL PACK

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Foreword

Herbert Smith Freehills is a global top tier law firm with a first class technology practice as well as a sector focus on technology. We have 2,900+ lawyers in 26 offices, spanning the UK, Australia, Asia, Europe, the US and the Middle East.

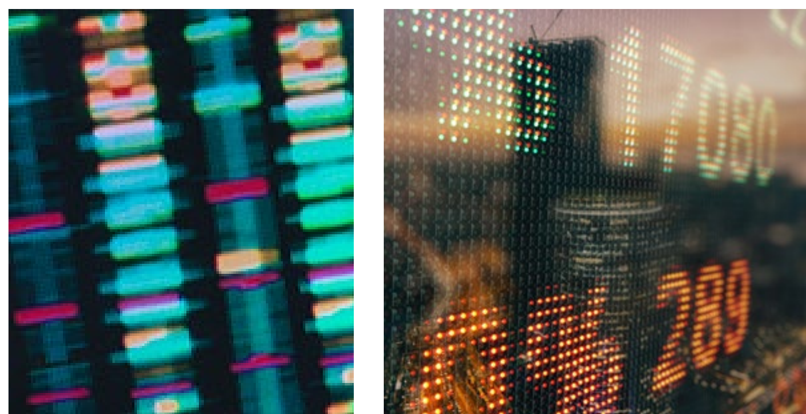
We work for some of the largest and most ambitious multinationals across all major regions of the world, and help growing businesses expand wherever their strategy takes them.

We represent technology and technology-enabled companies, users of technology and investors focused on technology and this gives us a deep understanding of the relationships, opportunities, risks and strategies involved in the market.

As technology is increasingly driving innovation in all sectors, including financial services, energy, infrastructure and transport, we use our extensive global expertise in those sectors and our technology and data expertise to help our clients adjust to and gain from that innovation.

We also have extensive experience advising on VC investments in the technology and related sectors. We regularly advise corporates (including Sky and Mastercard), financial investors (including Goldman Sachs and Cabot Square) and investee companies (such as ClearBank and Tandem Bank) on small to mid-cap corporate venturing and VC investments.

We recognise the disruption and the value that start-ups can bring to all sectors and we want to be a part of your pathway to success.



Welcome to the Herbert Smith Freehills start-up legal pack

This start-up pack has been prepared by the technology, media and telecommunications (TMT) team at Herbert Smith Freehills leveraging our experience advising clients at different stages of the corporate life cycle and on a spectrum of issues relevant to your business, including corporate, technology, data, intellectual property, cyber security, employment, and tax.

This start-up pack is intended to introduce you to a set of key agreements that any start-up company should consider putting in place at the first stage of its development or, in some cases, having ready in their back pocket for specific circumstances. The different sections of this start-up pack describe the purpose of each document, any limitations associated with its use, and what is (in our experience) the common or market position around certain issues. This start-up pack also highlights areas that tend to be more heavily negotiated or that you should consider in more detail.

Building strong and adequate legal foundations for your business can have a big impact on the long-term success of your company. The purpose of this start-up pack is to help you start this process on the right foot.

We are deeply familiar with the form of transaction documentation often used in investments in the technology and related sectors and have developed clear views on the market practice for key transaction terms. The contents of this start-up pack have therefore been selected and prepared on the basis of our experience.

Our start-up pack includes templates for the following key agreements, which you will need to tailor to your specific circumstances:

- IP assignment agreement
- Consulting agreement
- Contract of employment and employment offer letter
- Website terms and conditions
- Non-disclosure agreement

At the end of this start-up pack, we have also included a venture investing 'jargon buster' – please refer to the glossary.

The contents of this start-up pack are provided on an open-source basis and are made available freely. This start-up pack is offered for educational purposes and you are free to share it with other people in the start-up community.

Please remember that this start-up pack and your use of any of the documents provided herein are subject to the **terms and conditions of use** stated on the final page. This start-up pack and the embedded templates reflect the current law in England and Wales as of February 2018.

Subscription and shareholders' agreement and articles of association

In a venture capital investment scenario, there are two key documents which will need to be entered into: a subscription and shareholders' agreement (the "**SSA**") and the new articles of association (the "**Articles**") of the company in which the investment is being made. Templates for both of these documents can be found on the British Private Equity and Venture Capital Association ("**BVCA**") website together with explanatory notes – click here to access these. The BVCA is the industry body for the private equity and venture capital industry in the UK, and investors will be familiar with these template documents which are frequently used as a starting point for venture capital investments.

The subscription and shareholders' agreement

The SSA, also known as an 'investment agreement', is (unlike the Term Sheet, which is entered into prior to the due diligence process, and which you should ensure is non-binding) a legally binding document which should largely reflect the provisions of the Term Sheet. The exception to this is where issues have arisen in the due diligence process which need to be dealt with specifically in the SSA.

The SSA will typically be entered into between the investor(s), the existing shareholders in the company (usually the founders) and the company itself. The SSA is a neutral document and does not necessarily favour any one party in particular. The investment agreement essentially documents the relationship between each of these parties and sets out the specifics of the investment in terms of the number and class of shares that the investor will receive (or 'subscribe for', to use the technical terminology) and the amount that they will pay for these shares.

The SSA will also typically contain a set of warranties about the company (see Clause 5 and Schedule 5 of the BVCA SSA). These are essentially statements of fact which, if untrue, may give rise to legal liability on the part of the company. For example, the investors will usually require a warranty that the founders are the legal and beneficial owners of the existing shares in the company and that all factual information contained in the business plan is (at the date of the agreement) true and accurate. Whilst the warranties do give the investors some legal protection against inaccurate or false information provided by the company and the founders, their primary purpose is to flush out information which the investors might want to know prior to proceeding with their investment. Any such information will usually be disclosed by the founders in a separate Disclosure Letter which will in turn refer out to a bundle of supporting documentation, called the Disclosure Bundle. In other words, the warranties in the SSA are given on the understanding that they are subject to and qualified by the disclosures made in the Disclosure Letter.

In addition to the warranties, SSAs often contain a list of matters that will require consent from the investors (see Clause 10 and Schedule 6 of the BVCA SSA), such as, alterations to the company's share capital or the provision by the company of guarantees or indemnities to third parties. These consent requirements are intended to prevent the company from doing anything (without consent) that would adversely impact the investors' investment, whether directly (eg by diluting the investors' shareholdings) or indirectly (eg by affecting the value of the company).

Finally, the SSA will contain various information sharing provisions (see Clause 9 of the BVCA SSA). These require the company to share certain categories of information (typically financial information and accounts) with the investors on a regular basis. In addition, the investors will often be entitled to request any other information from the company that they reasonably require from time to time (as per Clause 9.5 of the BVCA SSA).

Please note that the BVCA SSA makes various assumptions about the form and structure of the investment being made – the Practical Law drafting notes on the BCVA's website set out these assumptions in more detail. You should ensure that these assumptions are correct before using the BVCA SSA template.

The Model Articles

The articles of association are a document that all companies incorporated in the UK must have and which dictate how the company is managed from a corporate governance perspective. If you have set up a shell company prior to the investment then you may already have had to provide articles of association for the company, as part of the incorporation process. However, these are typically Model Articles based on a template provided under statute and they are unlikely to adequately provide for all the scenarios that will need to be addressed post-investment.

The key part of the articles of association from an investor perspective will be the provisions which deal with the rights attaching to the different classes of shares, the procedure for the issue and transfer of shares and the procedure for holding shareholder and board meetings and passing resolutions. The investors will want to make sure that these provisions give them adequate protection against dilution of their shareholdings and that they have sufficient oversight of the company strategy and direction (which will largely be determined as part of the board and shareholder meetings referred to above).

Please note that the articles of association are a public document that must be filed with Companies House (the company registrar in the UK) and consequently, any provisions which are of a commercially sensitive nature should appear in the SSA (which is a private document and does not usually require filing with Companies House) rather than the articles of association.

Intellectual property rights assignment

Intellectual property rights ("**IPRs**") are vital to a technology company's business. You will need to take care when executing any contractual document relating to sharing or using IPRs, whether those IPRs belong to your company or are owned by a third party, to make sure that the contract being entered into has the intended legal effect. We always suggest that you seek specific legal advice on this matter either from your in-house legal team or, where necessary, from your appointed external legal advisors.

In order to transfer the ownership of IPRs from one person to another, you will need to execute an assignment of the IPRs in question. An assignment of title is not effective unless it is in writing signed by or on behalf of the assignor. Other than this formality, the assignment does not have to be in any particular form.

The template document below transfers the ownership of IPRs belonging to an individual (for example, rights developed by an employee of your company before they were employed by you, or a director or shareholder of your company) to another party. This is a scenario which often needs to be addressed as a part of a due diligence process in preparation for external investment or an acquisition.

On signature of the IPR assignment (and subsequent registration of the document in certain circumstances), the transferor will lose all of their rights of ownership in the relevant IPRs.

The template IPR assignment below should only be used where the IPRs to be transferred are readily identifiable and can be clearly defined in Schedule 1 of the template and you will need to make sure that sufficient details are included in the document before it is signed. If the IPRs are not correctly described in the agreement, the assignment may not be effective or may not transfer the intellectual property that you think it transfers. If you are in any doubt, seek legal advice.

Do not use this IPR assignment template where the IPRs being transferred are not readily identifiable and cannot be defined in Schedule 1 of the template.

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"If the IPRs are not correctly described in the agreement, the assignment may not be effective"

Consulting agreement

For a start-up company which is at the early stages of considering whether to expand its workforce, it may be preferable to hire consultants who can have more hands on deck during busy times, without the ongoing commitment of hiring employees. Consultants can also provide specialised expertise that may be difficult to fill from the employee workforce.

A consultancy arrangement may be an attractive option for both the start-up and the consultant, in part because of the tax advantages. However, the fact that an arrangement is structured and documented as a contract for services and not a contract of employment will not be conclusive as a matter of employment law or with regard to the individual's tax status. The question of whether the consultant is employed, self-employed or a worker is important because, among other things, it will determine the basis on which the consultant's income is taxed, whether the consultant will have the benefit of various employment protection rights available to employees, or the more limited rights available to workers, and also whether the start-up may be vicariously liable for the tortious acts of the consultant.

When you hire a consultant, you need to ensure that:

a) the consultant is prevented from using or disclosing your company's confidential information and trade secrets;

b) your company will own the intellectual property rights in work product created by your consultants; and

c) you minimise the risk that the consultant will be classified as an employee.

The best way to accomplish these objectives is by having each consultant sign a consultancy agreement.

The template consultancy agreement below is designed to be used where an individual consultant provides consultancy services to your company and is drafted on the basis that the consultant is genuinely self-employed and is not an employee or worker of the client. It is intended to be a reasonable and relatively balanced starting position between you and the consultant and therefore, depending on the circumstances, certain terms could be amended to favour your company more strongly (eg there is currently a thirty day mutual termination right, payment is due from the company thirty days from receipt of an invoice, and the company is liable to pay the consultant's reasonable expenses incurred in the course of the engagement).

Do not use this consultancy agreement where the consultancy services are provided by the individual through a service or loan-out company.

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"The question of whether the consultant is employed, self-employed or a worker is important because, among other things, it will determine the basis on which the consultant's income is taxed"

Contract of employment and employment offer letter

Hiring high quality employees is one of the keys to your company's growth. As you hire, having formal employment agreements with your employees is a must. Matters to be addressed in the contract will include the duties of the employee, their rights and salary package, disciplinary and grievance procedures, the circumstances in which either party may end the arrangement and any post-employment restrictions.

For a start-up at the early stages of considering expanding its workforce, it will be beneficial that you take a consistent approach to your various employment contracts. With a few basic templates for employment agreements and an employment offer letter, you can cover nearly all of your hires.

For technology start-ups in particular, the contract of employment must cover protection of your company's confidential information and trade secrets, and ownership of the intellectual property rights in work product created by your employees. Both of these points have been addressed in the template employment contract provided below.

Under the General Data Protection Regulation (the "**GDPR**"), which comes into force on 25 May 2018, for an employee to consent to your company processing their personal data, their consent must be freely-given, specific, informed and revocable. The GDPR makes it clear that, given the imbalance of power between employer and employee, employees can only freely give consent in exceptional circumstances. We have sought to address this issue in the contract of employment by including an alternative legal basis for your company to process employee data.

This contract of employment is designed to be used for non-executive, simple hires. **Do not use this contract for executive hires or more complex or unique arrangements** as such arrangements will need to address things like relocation benefit packages, bonus and commission programmes, severance, change of control benefits, and certain tax issues.

This start-up pack and your use of the document provided below are subject to the **terms and conditions of use** stated on the final page.

"...the contract of employment must cover protection of your company's confidential information and trade secrets"

DOWNLOAD CONTRACT OF EMPLOYMENT TEMPLATE

DOWNLOAD EMPLOYMENT OFFER LETTER TEMPLATE

Website terms and conditions

One of the things that a start-up will want to do at an early stage is to set up a website, whether simply for promotional purposes or for e-commerce activities. It will therefore need to have in place certain website terms of use ("**website T&Cs**") to govern its presence online.

The website T&Cs provided below cover key issues that should be addressed, including corporate information about the website owner, rights to modify or withdraw access to the website, disclaimers with regards to the content and performance of the website (including in respect of viruses), security obligations on the users regarding their account and any passwords, the position regarding intellectual property rights in the website and its contents, and what the users may or may not do with such contents. They also include provisions governing the uploading of content by users and linking to the website.

These website T&Cs are drafted generically but will need to be adapted for the types of activities that users will be undertaking on the website (eg where they purchase goods or services via the website). The relevant sector or industry that the company operates in will also need to be considered, particularly if this involves the financial services or other regulated services industry.

These website T&Cs are drafted for both business users and consumers. However, please note that the interaction with consumers is more strictly regulated by legislation and in particular, it is more likely that courts may find certain terms to be unfair in business-to-consumer contracts rather than business-to-business contracts. Therefore, if the visitors of your website are likely to consist to a large extent of consumers, you may wish to amend these website T&Cs to give them more generous protections, or split this document into two versions, one applicable to business customers and another to consumers.

"...interaction with consumers is more strictly regulated by legislation and in particular, it is more likely that courts may find certain terms to be unfair in business-to-consumer contracts rather than business-to-business contracts"

Legal enforceability

In order to ensure that the website users are legally bound by the website T&Cs, you should ensure that the website T&Cs are adequately incorporated into a binding contract with the users. If possible, the user should have to click on an 'accept' button before being given access to the website to indicate that they have read and accepted the terms. This "click-wrap" method is considered the best way to ensure that the user has entered into a valid contract with the website owner. A copy of the website T&Cs should still be available on the website for users to view and/or download at any time. Alternatively, a link to the website T&Cs should be prominently displayed on each page of the website in order to bring the user's attention to their existence. However, the main problem with this 'browse-wrap' method is that there is no way for the user to indicate acceptance with the website T&Cs and therefore, there is a risk that no legally enforceable contract is in place.

Website terms and conditions (continued)

Policies

The website T&Cs usually refer to a number of other policies which are intended to be used in conjunction. It is customary to include links in the website T&Cs to the following policies:

1. **Privacy Policy**: Assuming that your website will be collecting personal data on its visitors, this means you will have legal obligations under applicable data protection legislation, including the GDPR. Therefore, a privacy policy is often used to set out obligations regarding the protection of the users' personal data and also to obtain any implied consents from the users.
2. **Acceptable Use Policy**: You should also have in place a policy which sets out the content standards that the website users must comply with when they are accessing or using the website.
3. **Cookies Policy**: Website owners are legally required to give users certain information about their use of cookies and this is normally included in a separate cookie policy.
4. **Website Terms and Conditions of Supply**: If you are selling goods and/or services through the website, you will also need to put in place a separate contract setting out the terms and conditions on which you will supply such goods and/or services and reflecting any applicable legal and regulatory requirements (eg with regards to distance selling).

Please note that these website T&Cs do not contain templates of such policies and you will need to seek separate legal advice with regards to their contents.

Jurisdiction

Your website may in theory be accessed anywhere in the world (unless this is specifically restricted). As a general rule, it is therefore preferable to choose a governing law and jurisdiction to apply in the event of a dispute. The combination of English law and the jurisdiction of the English courts is considered a safe choice because it is highly likely that foreign courts would follow a decision reached on this basis. These website T&Cs have been drafted using this combination. If no governing law or jurisdiction would be specified, a claimant could theoretically start proceedings in any (and possibly more than one) country. It would then be up to the particular country (or each of the countries) to apply their own rules on conflict of laws and decide whether they accept jurisdiction.

Mandatory laws

Please remember that there are laws and regulations applicable in those jurisdictions where the website is made available which could override the provisions of the website T&Cs. To address this issue, it is helpful to add a severance clause to state that if any parts of the website T&Cs are illegal or unenforceable, they will be modified to the extent possible, or deleted, but without affecting the remainder of the contract.

The template website T&Cs provided here could also be used for mobile apps but the document will require certain amendments. Please seek legal advice in order to update the template for this purpose as appropriate.

This start-up pack and your use of the document provided below are subject to the **terms and conditions of use** stated on the final page.

DOWNLOAD WEBSITE TERMS AND CONDITIONS TEMPLATE

Non-disclosure agreement

Information about your business, affairs, customers, plans, intentions, market opportunities operations, products, inventions, trade secrets, designs or software could all be considered vital to the potential growth of your company and you will need to make sure it is protected when entering into discussions with potential customers, partners or purchasers.

A non-disclosure agreement (known as an "**NDA**") is used for this purpose. When you enter into an NDA, you need to make sure that:

a) the purpose for which any confidential information is going to be shared is explicitly set out;

b) the other party is under an obligation to keep the information secret;

c) you exhaustively define the situations where you or the other party can pass the confidential information to a third party (eg to an employee or if you are required to do so by a court); and

d) what should happen to the confidential information on expiry of the agreement (ie should the information be returned or destroyed).

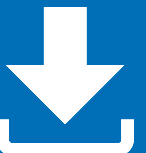
The NDA provided here is designed to be used where both you and the company that you are entering into confidential discussions with will be disclosing confidential information to one another. Both you and the other party promise to keep each other's confidential information secret and each party will return or destroy all confidential information at the end of the NDA.

Do not use this NDA where only one party is disclosing information to the other or where you are entering into a long term commercial arrangement with a third party.

This start-up pack and your use of the document provided below are subject to the **terms and conditions of use** stated on the final page.

"The NDA provided here is designed to be used where both you and the company that you are entering into confidential discussions with will be disclosing confidential information to one another"

DOWNLOAD NDA TEMPLATE



Glossary

Amount of Liquidation Preference

The amount of the liquidation preference is typically a function of the perceived risk of the investment.

The most common approach is to provide a liquidation preference equal to the purchase price. This provides investors with some assurance that they will receive their investment back before amounts are distributed to the ordinary shareholders. It also helps to align the interests of the investors with those of the founders, management and other ordinary shareholders by requiring preference shareholders to convert their shares into ordinary shares to obtain returns in excess of their initial investment (depending upon the extent of any participation rights in the residual distribution—see the "Participation Rights" definition below).

In rare cases, where there are significant risks associated with an investment, investors may sometimes require that the liquidation preference be a multiple of the purchase price of the preference shares (sometimes expressed as a 2x or 3x preference).

Angel Investors

Angel investment is a fairly common source of financing for early stage start-ups, as angel investors can bridge the gap between 'friends and family' funding and larger venture capital funding. Angel investors are high net-worth individuals, many of whom have experience in the start-up community and can be a useful resource for networking and management advice in addition to a source of funding.

Angel Networks

Organisations, funds and networks made up of Angel Investors formed for the specific purpose of facilitating angel investments in start-up companies.

Anti-dilution Protection

Mechanisms by which certain shareholders' economic ownership in the company may be protected from dilution (upon the issuance of additional shares). Major venture investors typically request protection against possible dilution in their holdings that may occur as a result of additional issuances of shares at a lower purchase price than paid by the investor, without the investor having to make a material new investment. These price-based anti-dilution adjustment mechanisms typically effect some change to the conversion ratio of the preference shares (into additional ordinary shares), and in general, are divided into broad-based weighted average, narrow-based weighted average and full ratchet mechanisms. Weighted-average formulas are more favourable to founders and are the most common.

Articles of Association

The Articles of Association are a contract between the shareholders of a company which must be filed at Companies House. The purpose of the Articles is to regulate the internal management of the company and how power and control is shared between the shareholders of the company and its directors. The Articles address not only the day to day practicalities of running the company, but also other important information regarding the make-up and ownership of the company. The most common form of Articles of Association for newly formed companies is the Model Articles.

Authorised Shares

A company's Articles of Association can (although it is not necessary under the Companies Act 2006) set forth the maximum number of shares that the company may issue of each class and series of shares, or authorised shares. The authorised number of shares available to issue can be increased by amending the company's Articles of Association.

Automatic Conversion

It is typical in venture capital financings to include provisions for automatic conversion of all of the preference shares into ordinary shares upon the vote or written consent of holders of a defined minimum number of shares. This helps to avoid the risk of holdouts in a situation where the conversion (or a transaction contingent upon the conversion) is in the best interests of the company and the shareholders as a whole. It is also typical to provide for automatic conversion in connection with an IPO that meets specified criteria as to size and valuation. Underwriters for the IPO will want the company's capitalisation structure to be simplified to the extent possible to facilitate the underwriters' marketing efforts.

A new investor in a later-stage financing should exercise care in negotiating the automatic conversion provisions, particularly if the new investor is entitled to a larger preference or has priority relative to other series. The new investor should be cognisant of the risk that the other investors may be able to effectively eliminate any preferences or priority by effecting an automatic conversion through a class vote of all of the preference shareholders voting as a whole. To protect its liquidation preference, the new investor may want to request a higher vote threshold or a separate series vote.

Bridge Financing

Sometimes companies need a short term cash infusion to get them enough operating capital to get to a point where they can raise a successful financing round or sell the company on more favourable terms. Some companies will raise a "bridge financing" that provides a bridge between their current state and the desired outcome. Often this is in the form of a convertible loan note.

Broad-based weighted-average

A 'weighted-average' formula accounts for the number of shares issued in the new financing and the number of shares already outstanding (in addition to the respective prices at which the shares were issued) in adjusting the conversion price. A 'broad-based' formula calculates the adjustment by factoring a larger number of shares into the average, which results in a smaller adjustment than under a 'narrow-based' formula. A broad-based formula would typically treat all shares issuable upon exercise of outstanding options, warrants and convertible securities (in addition to shares that are actually outstanding) as "outstanding" for the purposes of the adjustment formula.

Call Option

A type of option (but not an obligation) for a purchaser to acquire a specified number of shares from a seller at a specified price and exercisable during a specified period, or upon the occurrence of specified events.

Cap Table

A cap table tells you "who owns what." It is a spreadsheet of all the shareholders and security holders in the company – listing outstanding ordinary shares, preference shares, option grants and restricted shares, warrants, convertible securities, shares reserved for issuance under company option plans, etc. A cap table is often segmented to describe each of several funding rounds in the company and clearly differentiates between holders of different classes of shares. The number of the company's issued shares should equal the total number of shares held by the sum of all the investors and other security holders as reflected in the cap table.

Conversion Price Cap

A conversion price cap is the maximum valuation at which a convertible loan note converts at the time of the equity financing resulting in the conversion, regardless of the valuation agreed to by the company and the new equity investors. It comes into play where an equity financing occurs at a valuation above the valuation cap (ie estimated valuation at the time the notes are issued); in such circumstances, the note holder may convert the note at a discounted price relative to that paid by investors in the equity financing. It is important that companies consider the impact the cap might have at the time of a future fundraising.

START-UP LEGAL PACK HERBERT SMITH FREEHILLS

Glossary (continued)

Conversion Rights
Preference shares issued in venture capital financings are typically convertible at the election of the holder into ordinary shares. Since ordinary shares typically receive the residual amount in connection with any liquidation (after payment of any liquidation preference to the preferred shares), the ability of preference shares to convert to ordinary shares enables the preference shares to participate in any upside in the event the liquidation amount exceeds the liquidation preference.

Convertible Loan Note
A convertible loan note is a unique form of debt that converts into equity, usually in conjunction with a future equity financing round (but will usually be an established minimum size of that financing to trigger automatic conversion). The investor loans money to a start-up with the expectation they will receive equity in the company in the future at a discounted price paid per share to future investors and/or a conversion price cap. Additional customary terms include optional conversion if the automatic conversion terms are not met, possible conversion or premiums on a change of control, and interest.

A convertible note is often used to facilitate investing in a company which is establishing a valuation. This may be desirable for many reasons, including efficiency or the particular business stage (eg where it is too early to attract money at an acceptable valuation or a need for cash arises at a point when a valuation inflection point is on the horizon).

Co-Sale or Tag Along Rights
Tag along rights give investors the right to sell their shares in the same proportions and on the same terms as the founders, managers, or other investors, should any of those parties receive an offer for some or all of their shares which they wish to accept. Most often sought by investors who will hold a relatively small portion of a company compared to such founders, managers or other investors.

Dilution
Dilution is a reduction in the ownership percentage of the issued share capital in a company caused by the issuance of new shares. Dilution can also occur when holders of option grants (such as company employees) or holders of other options (such as warrants) exercise their options. When the number of shares outstanding increases, each existing shareholder will own a smaller, or diluted, percentage of the company, making each share less valuable. The potential upside of share dilution is that the additional capital the company receives from issuing additional shares can improve the company's profitability and the value of its share capital.

Dividends
Venture-backed companies are not typically in a position to pay dividends. The most common approach to dividends is therefore to have non-mandatory, non-cumulative dividends, which means that dividends will only be paid if (and to the extent) declared by the board.

Down Round
A financing in which a company sells shares at a price per share that is less than the price per share at which it sold shares in an earlier financing (where the valuation of the company has decreased significantly since earlier rounds of financing).

Drag Along Rights
Drag along rights enable majority shareholders to drag along minority shareholders in an acquisition. This right is often negotiated by investors so that they can sell a company through a share sale even when minority shareholders do not want to sell their shares. Founders, who are usually minority shareholders, may be resistant to granting these rights because they can enable investors, who usually have a liquidation preference, to negotiate sales where the investors benefit and the minority shareholders do not.

Equity
Ownership interest in a company, usually in the form of shares or option grants.

Exercise Price
Every option grant has an exercise price, also called the strike price, which is the price at which a share can be bought. Tax law limits the exercise price that can be assigned to option grants to the fair market value of the underlying share on the day the option is issued to prevent abuse of options as tax deferral instruments, because options are not taxable until they are exercised. If the price of the underlying shares is above the exercise price of an option, it is "in the money" because profit can be derived from exercising the option. Conversely, if the price of the underlying shares is below the exercise price of an option, it is "out of the money" and will not be exercised because exercising it will result in a loss.

Exit Strategy
An agreed strategy for investors and employees to see a return on the shares they have purchased. This will normally take the form of an IPO or a sale of the company. Likely to be at a developed stage of the business life cycle.

Fair Market Value
An acceptable selling price to an independent third party. What a willing buyer would pay a willing seller on a transaction negotiated at arm's length.

Founder
A person who founded a company and was an initial subscriber for shares in the company.

Full Ratchet
Adjusts the conversion ratio of preference shareholders to reflect the new lower price at which the new shares are issued (**without** accounting for the number of shares to be issued or previously outstanding). Because it does not calibrate for differences in the size of a new issuance relative to previously outstanding shares, a full-ratchet formula tends to result in more dramatic changes than weighted-average formulas. Often such a provision will be limited in duration (eg applicable to issuances that occur within a certain number of months or applicable through the closing of the company's next financing of a specified size). From the company's standpoint, if a full-ratchet formula is used, it is important to pay extra attention to ensure that the exceptions from its application are broadly crafted so as not to trigger adjustments for share issuances that are not related to equity financings.

Fully Diluted (Capitalisation)
All issued shares (ordinary shares and preference shares, as if converted to common shares), issued options or warrants, and options reserved in the employee share option pool. It assumes that the entire employee share option pool has been granted, and that all of those options have been exercised. Fully-diluted capitalisation is useful because it reflects an investor's true ownership position.

The parties will need to agree upon whether any unissued options and shares attributable to any **increase** in the option pool in connection with the financing will also be included in the fully-diluted number. In connection with a financing, the parties will typically assess whether to increase the option pool (to ensure sufficient shares for management, employees, etc, on a going-forward basis). The purchase price per share will be affected by whether or not these additional shares are included in the fully-diluted number.

Existing shareholders will benefit if the price per share is calculated using a fully-diluted number that does not include unissued options and any increase in the option pool. In contrast, the investors will want the dilutive effect of an expanded pool to be borne by existing shareholders.

Investment Bankers
Representatives of financial institutions engaged in the issue of new securities, including management and underwriting of issuances as well as securities trading and distribution.

Glossary (continued)

Investor

The common term for a person or company other than a founder or employee that purchases shares in a company.

IPO or Initial Public Offering

The regulated process by which a private company first lists or registers its shares for trading in public markets ("going public"). Companies making an IPO need to comply with legal registration requirements as well as public reporting requirements. To complete an IPO a company must engage banks as underwriters who can value the company and price securities and ultimately distribute them, and the company must market the securities to potential investors. To get approval from the stock market regulator to move forward with an IPO, a company must file certain documentation including a prospectus on the company and other detailed disclosures. Once the documentation is filed, the regulator makes comments that require revisions to the form, and the back and forth typically takes ten to twelve weeks before the shares can be publicly listed.

Issued Shares

Issued shares (also referred to as outstanding shares) refer to the number of shares that have been issued and are outstanding at a given time. Practices vary, but typically between 5 and 10 million shares are issued to the founders of a company at incorporation.

Key Person

The term given to specific employees within a company whose value has been identified as being material to the company. Key persons are often the subject of specific company insurance policies and more sophisticated employment agreement terms.

Liquidation Preference

A basic feature of preference shares is the preferential right (ie ahead of other shareholders) to receive distributions upon certain events. These liquidation preferences apply to distributions in connection with a liquidation and dissolution of the company (ie a traditional liquidation) and distributions in connection with the sale of the company (ie a "deemed" liquidation), and allow the investors to get their invested capital back in a liquidation event before any proceeds from the liquidation event are distributed to the founders, management and employees.

The structuring of liquidation preferences is an issue of critical importance to investors and founders. In particular, founders (who will typically be in a subordinate position by virtue of holding ordinary shares) should take care to understand the effect of liquidation preferences in various scenarios. Founders sometimes focus on IPO scenarios (in which liquidation preferences typically do not come into play) without due regard for other, more likely liquidation scenarios in which investors will have a preference.

Investors should also exercise some discretion in negotiating liquidation preferences. Liquidation preferences, particularly those that provide for multiple returns or participation rights, may result in skewing management incentives toward an IPO where an acquisition may be a more realistic or strategically desirable outcome.

Narrow-based weighted-average

A 'weighted-average' formula accounts for the number of shares issued in the new financing and the number of shares already outstanding (in addition to the respective prices at which the shares were issued) in adjusting the conversion price. A "narrow-based" formula does not normally take into account unexercised options or warrants or outstanding convertible notes, which results in more significant adjustments than under a broad-based formula. Some very narrow-based formulas include only the outstanding preference shares in the calculation. It is more favourable to investors than a broad-based weighted-average formula.

Option Grant

An option grant is a right to acquire a set number of shares (usually ordinary shares) at a set price over a period of time. Typically an option grant can be awarded to an employee, advisor or other individual who performs a service for the company, and the option can be exercised during the term of service to the company or for a finite period of time following cessation of services.

There are several terms that are important when considering whether to grant options including the exercise price, number of shares, vesting schedule (meaning, the schedule that defines when shares underlying the option may first be acquired), and the period of time in which the option can be exercised.

Ordinary Shares

Ordinary shares are a security that represents ownership in a company. Holders of ordinary shares exercise control by electing a board of directors and voting on company actions. Ordinary shareholders are on the bottom of the priority ladder for ownership structure. In the event of a liquidation event, ordinary shareholders have rights to a company's assets only after bondholders, preference shareholders and other debtholders have been paid in full. This makes ordinary shares generally riskier than debt or preference shares.

Participation Rights

With 'participating' preference shares, the preference shareholders are entitled to receive their preference amount first in a liquidation event (plus accrued and unpaid dividends), with any remaining preference shares on an 'as-converted' basis. Participating preference shares provide a significant benefit to investors at the expense of the founders, whose right to any residual amount after payment of the preference is cut by investor participation in the distribution of the remaining amounts. A participation feature may be more justified where the risk associated with the investment or, in a later stage investment, the possibility of a sale shortly after the investment, may justify a premium.

With 'non-participating' preference shares, the preference shareholders are entitled to receive only the amount of their preference (typically the amount paid for the shares), plus any accrued and unpaid dividends, upon a sale or liquidation of the company. Any remaining proceeds are distributed solely to the ordinary holders. If the ordinary holders would receive more per share than the preference shareholders upon a sale or liquidation (ie typically when the company is sold at a high valuation), the preference shareholders can convert their shares into ordinary shares and give up their preference in exchange for the right to share pro rata in the full liquidation proceeds. Management and other common holders generally favour non-participating preference shares since it requires that the preference shareholders convert and stand on equal footing with the ordinary shareholders to receive a gain on their investment beyond the negotiated preference amount.

Post-money (Valuation)

Valuation of a company immediately after a new round of investment, that is, the pre-money valuation plus the total consideration of the new round of investment.

Pay-to-Play

Requires that investors participate in the present financing or future financings to retain anti-dilution or other rights. Pay-to-play is a nonstandard provision. It is often employed to effect a significant restructuring of the company's capital structure in connection with a highly-dilutive, or 'wash-out', financing, and can also serve more generally to discourage investors from free riding on the continued financial support provided by other investors in future financings (dilutive or otherwise).

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Glossary (continued)

Pre-emptive Rights The right of a shareholder to provide financing/purchase additional shares in the company on the same terms as offered to other parties up to the amount necessary to maintain such holder's pro-rata ownership percentage in the company.

Pre-money Valuation Valuation of a company agreed upon by the existing owners and the new investors, immediately prior to a new round of investment.

Preference Shares Most likely class of share for angel investments or venture capital equity investments. Preference shares rank in priority to ordinary shares but are subordinate to debt. The likely rights attaching to preference shares include voting, dividend, management, conversion and other rights and privileges over and above the rights attaching to ordinary shares.

Protective Provisions Venture investors will often request special approval rights with respect to certain matters of particular significance to their investment. These special class voting rights are generally referred to as 'protective provisions'.

Protective provisions can serve an important role in protecting the interests of investors (particularly where the investors will have a minority position in the company), and there are a number of fairly standard protective provisions, including amending Articles of Association to affect rights of preference shareholders; increasing/decreasing authorised preference shares; authorising or issuing equity securities senior to or on parity with preference shareholders; liquidation, dissolution or winding-up; merger, acquisition or sale of substantially all assets; dividends, distributions and share repurchases (subject to customary exceptions).

Purchase Price Per Share The pre-money valuation of the company divided by the fully-diluted number of shares outstanding.

Put Option An investor's right to force the company to purchase his/her shares. Used by investors to assure eventual liquidation of their investment. Opposite of a call option.

Redemption Rights A primary goal of venture investors is ensuring the eventual liquidity of their investment. Redemption features are intended to provide this liquidity at a fixed time in the future.

It is unusual for venture capital investors, however, to request redemption rights. In most cases, start-ups (whose expenses typically outstrip any revenues) will not have sufficient cash resources to make redemption a realistic alternative and will not otherwise have the ability to refinance its capital structure to accommodate the redemption. Consequently, investors in venture financing transactions primarily focus on an IPO or a sale of the company as the means to achieve liquidity.

There may, however, be circumstances where redemption rights may be more appropriate. For example, a minority investor in a later-stage, profitable company may want to have some ability to exit the investment. Note also that, even if redemption rights are not formally exercised, investors can use the threat of redemption as leverage to influence the company's decision making (eg forcing the company to more seriously consider an IPO or a sale).

Registration Rights It is important for investors to have a means to eventually liquidate their investments. Securities sold in private financings are typically subject to restrictions on resale under securities laws. Although there are limited exemptions from these resale restrictions, these exemptions subject the investors to holding periods and other potentially applicable conditions that may limit the ability of investors to resell their shares.

To help ensure their ability to resell the shares, investors will often request registration rights. Registration rights enable investors to require that the company register the investors' shares for resale under certain circumstances. Although it is somewhat unusual for registration rights to be exercised, the availability of registration rights can serve as leverage in affecting the timing of an IPO or other liquidity event and the extent to which investors' shares are included in any registered offering.

Seed Financing The initial capital used to start a business, sourced from venture capital firms.

Series Financing Refers to the rounds of equity venture capital financing that start-up companies rely upon for investment. The stages of series financing typically include Series Seed; Series A; Series B; Series C and so on. A Series Seed or Series A round is typically the first round of venture financing and may follow an angel investor round or convertible loan note financing.

Subscription An application to purchase shares in the company which have not previously been issued to anyone else.

Subscription Price The aggregate price paid to purchase new shares in a company.

Term Sheet A preliminary document that often includes the key terms of an investment in a company including agreed-upon valuation of the business, including the proposed capitalisation table; key financial and legal terms; rights of both parties.

Unissued Share Capital Shares that a company has the power to allot or issue but which it has not done so yet.

Venture Capital Firm A financial institution specialising in the provision of equity and other forms of long-term capital to enterprises, usually to firms with a limited track record but with the expectation of substantial growth. A VC firm may provide both funding and varying degrees of managerial and technical expertise.

VC firms are organised as funds, much like hedge funds or mutual funds. The fund managers, who are called "general partners", get about 2% of the fund annually as a management fee, plus about 20% of the fund's gains. The GPs raise the bulk of the fund's investable capital from "limited partners", usually institutions such as university endowments, insurance companies and pension funds. This is the money that is invested in the start-ups.

Glossary (continued)

Voting for Directors

Venture investors will typically request the right to designate a representative to serve on the company's board of directors. This can be accomplished by providing for class voting rights for the election of directors in the company's Articles of Association or by a voting agreement in which the major shareholders agree to a particular allocation of board seats. Investors tend to prefer class voting rights over voting agreements, since class voting rights tend to be more reliable than contractual voting obligations.

It is typical for an early-stage company to have a board comprised of three or five members (an odd number helps to avoid voting deadlocks). This enables adequate representation of the founders and the outside investors without the administrative burdens associated with a larger board. For example, if the company has a single lead investor, the parties might agree to have a three-person board, with one designee of the Series A investor, one ordinary shareholder designee (typically the CEO/founder) and one independent person (approved by the investor and the ordinary shareholders). Similarly, with two lead investors, a common approach is to have five directors, with two Series A investor designees, two ordinary shareholder designees (which will often include the CEO) and an independent director.

Warrants

Securities that give equity or debt holders the right, but not the obligation, to buy shares at a price for a given period of time. Similar to share options (for non-employees) and often offered to investors as a bonus for cash investment or to service providers in exchange for fees.

Vesting (Acceleration)

Some founders and key executives negotiate into their equity arrangements that they will be entitled to some form of acceleration of the vesting of their equity upon the occurrence of a triggering event. Typically, the triggering event is the sale of the company, but can also be an involuntary termination of employment.

Acceleration triggered solely by the sale of the company is called "single-trigger" acceleration and results in some or all of the vesting restriction lapsing in connection with the sale. This is designed to reward the employee for his/her contribution to a successful outcome for the company. "Double-trigger" acceleration requires two events to trigger acceleration.

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