# Know Your Terms: The Key Terms of a Venture Capital Deal

Kareem Zureikat - Senior Associate - Corporate / Mergers and Acquisitions / Commercial / Venture Capital and Emerging Companies

- Dubai International Financial Centre

The number of e-commerce startups in Dubai is burgeoning; so the Emirate has seen a significant increase in the number of private investors and venture capital funds active in this field. Growth during the early stages of a startup's cycle requires significant funding, and banks usually step away from investments which are considered high risk. Venture capital firms and private investors fill this space vacated by conventional financial institutions.

The relationship between the founder and the investors is critical to the growth and success of the business and should always be approached with care. Because founders will find themselves negotiating against their investors during each funding round, it is useful for both the founders and the investors to be well versed in some of the basic venture capital funding market practices and terminology. This will help their mutual expectations, and hopefully minimize areas of disagreement. A lack of this market knowledge may lead to protracted negotiations which can kill a venture capital deal outright or impair the surviving founder-investor relationship.

The following is a summary of the main documents and key provisions of an equity funding round for a startup.

**The Transaction Documents**

*Term Sheet*

Every venture capital transaction starts with the term sheet. Whilst a term sheet is typically expressed as a non-binding document, it is the foundation on which all other (binding) transaction documents are drafted. It is usual for investors and founders to outright reject any term in the (binding) transaction documents which does not reflect the provisions of the term sheet.

*Subscription Agreements and Subscription Letters*

In order to "lock-in" the investment, binding subscription agreements are prepared setting out the key terms of the investment. Investors (other than the lead investor) will sign a simple subscription letter confirming the investment amount per investor, the number and class of shares being issued in consideration for the investment and the expected date on which the round will complete.

A long form subscription agreement is commonly entered into between the company, the founders and the lead investor (and in certain instances, the co-lead investor(s)). This includes more comprehensive provisions normally geared towards protecting the lead investors' interest (such as warranties as to the condition, affairs and accounts of the business), and may also include requirements to restructure the company's management and operations either prior to or after the investment round.

*Shareholders' Agreement*

The shareholders' agreement is the key binding agreement and will reflect, in binding form, the terms agreed in the term sheet. It will set out the rights of the investors and the founders, and will contain provisions that govern the management and operation of the startup.

**Key Terms of the Transaction Documents**

As the party taking the financial risk, each investor will seek preferential economic (and occasionally voting) rights over the rights of existing shareholders (including the startup founders). A substantial portion of the provisions of each of the term sheet and the shareholder agreement will be geared towards protecting the investor's investment and ensuring that, at the appropriate time, the investor is able to liquidate its investment in priority (and on terms generally more favourable) to the previous round investors as well as the startup founder.

The following are the key terms which investors will seek to include in a venture capital transaction.

*Preferred Shares and Conversion*

New round investors are typically offered preferred shares (or generally shares of a different class to the founders), which carry certain preferential economic and voting rights over the founders' ordinary shares (Preferred Shares).

Preferred Shares are usually convertible into ordinary shares whenever this is beneficial to the investor(s). It is also common to detail circumstances or events which would lead to automatic conversion of the preferred shares, for example, in the event of an initial public offering of the company, where it is typically the case that only one class of shares (the ordinary shares) are listed on the exchange. The decision as to when the investor will convert its shares and the number of ordinary shares that it will receive in exchange is based on several factors, the most important being an assessment of whether or not the investor's liquidation preferences and participation rights (described below) would yield higher returns if the preferred shares were converted into ordinary shares at that time.

*Liquidation Preference and Participation*

A liquidation preference is a right of the investor to receive proceeds from a "liquidity event" in priority to other classes of shareholders. What this means is that an investor will receive payment, as a result of such "liquidity event", before any of the founders or holders of ordinary shares. The definition of a "liquidity event" can vary, but typically includes the sale of a majority of the startup's shares (or a sale of a controlling interest), a sale of a substantial portion of the startup's assets or the winding up of the startup.

A liquidation preference typically grants the preferred shareholder a minimum return equal to a multiple of the capital invested, in addition to any declared or unpaid dividends payable to the holder of the preferred shares. While investors may seek to negotiate higher return multiples, the standard market practice in the Middle East is to limit the liquidation preference payment to the capital invested by the investor, together with any declared or unpaid dividends locked into the entity.

By way of example, assume an investor made an investment of AED 1 million in consideration for 100,000 Preferred Shares, for a resulting ownership of 50% of the startup's share capital (i.e. the startup's entire share capital comprises of 200,000 shares). The terms of the investment include a liquidation preference equal to the full value of the AED 1 million investment. The startup does not perform as expected, and one year later, 100% of the startup's shares are sold to a private equity investor at a total valuation of AED 1.5 million. Given that our investor has a liquidation preference in respect of the full value of its investment, the investor will receive AED 1 million from the buyout, with the remaining AED 500,000 distributed to all shareholders pro rata. Had no such liquidation preference been included, the investor would have received AED 750,000, representing its 50% share of the total purchase price.

The holder of a Preferred Share will typically be entitled to "participate" in the proceeds of a liquidity event pro rata to its shareholding in the company. This right only crystallises after the preferred shareholder has received its liquidation preference described above. This would therefore mean that the preferred shareholder would first receive its capital invested before other shareholders (as provided for by its liquidation preference), and would then share (or "participate" in) the remaining proceeds of the "liquidity event" with all other shareholders pro rata.

Using our example above, in the event the investor also has participation rights, the investor would first receive its AED 1 million, and would then be able to participate, on a pro rata basis, with the remaining shareholders in the AED 500,000. The investor would therefore receive AED 1.25 million, which is its AED 1 million investment, plus its pro rata share (namely 50%) of the remaining AED 500,000, which is an amount equal to AED 250,000.

Liquidation rights and participation rights can carry significant implication for the return realized by the investor and the founders in some scenarios, so it is vital that legal and financial advice is sought prior to agreeing to confer any such rights under the term sheet or the shareholders' agreement.

*Anti-Dilution*

A key feature of these startup funding transactions is the anti-dilution right. This should not be confused with a pre-emption right (see "Share Transfer Provisions – Pre-emption rights" below for more details).

An anti-dilution right operates to protect an investor's ownership interest if the value of the startup diminishes after the date of the investment. Therefore, on a subsequent issue of new shares, if the shares are issued at a price-per-share that is lower than the price which the investor paid during its funding round (this is commonly termed a "down round"), the anti-dilution right would come into effect. The right is built into what is known as a "conversion price", which is the reference point of a price per share at which Preferred Shares would convert into ordinary shares.

Continuing with our case example, if an investor in a Series A funding round subscribed for 50% of the total shares at a price of AED 10 per share with a total investment of AED 1 million, that investor would receive 100,000 shares. If, during a Series B funding round, the startup's valuation has diminished, and new shares were offered to Series B investors at price of AED 5 per share, the Series A investor's anti-dilution right would kick-in and the Series A investor would be deemed to have originally invested at a price per share that is lower than AED 10. A lower conversion price translates to more shares, given that the value of the investor's subscription (AED 1 million) is divided by a lower price-per-share (for example a price of AED 5 per share).

There are two approaches to determining the conversion price; the first is the more simple approach of using a "full ratchet" conversion formula, where the share price originally paid (i.e. AED 10 in our example) is automatically reduced to the price-per-share of the new round (i.e. AED 5 in our example). The second, and more complicated approach, is using a "weighted average" conversion formula, which takes into account the weighted average value of previous issues of shares as well as the current issue. The more common approach in the region is the "weighted average" calculation.

*Control*

Lead investors will always wish to ensure that their investment proceeds are being employed for the agreed purpose. They would also want to make sure that the startup does not take any critical decision without the investor's approval. These decisions are commonly referred to as "reserved matters" and include any decision to (i) reduce or otherwise alter the rights attached to the investor's shares, (ii) involve material capital or operational expenditure or (iii) change the nature of the business. These are three examples of what is usually a two-page list of "reserved matters" in respect of which the investor would reserve a veto right.

Reserved matters typically operate at the board level, where the lead investor in a funding round would be given a board seat. It is a standard approach to have board meetings only deemed to be quorate with the presence of the investor-nominated director, and the "reserved matter" decision would only pass provided the investor-nominated director votes affirmatively on that decision. Reserved matters also operate on the shareholder level in respect of certain key decisions, including those which, as a requirement of applicable law, require the affirmative vote of the shareholders. In this instance, it is common for the “reserved matter” shareholder resolution to require the affirmative vote of a certain percentage of the holders of Preferred Shares.

*Share Transfer Provisions*

There are five key clauses that grant the shareholders of a startup (including its investors) certain protections in connection with the transfer of the startup’s shares or the issue of new shares by the startup. These are found in the shareholders’ agreement and are usually built into the articles of association of the startup.

*Pre-emption rights*

A pre-emption right is offered to existing shareholders in respect of any future issues of shares (or other “equity securities”) by the startup, giving the existing shareholders the first option to purchase the newly issued shares. A pre-emption right typically offers the shareholders a right to maintain (or increase) their ownership percentage by subscribing for new shares on a pro rata basis. A failure by the existing shareholders to subscribe for the shares typically allows the startup to offer these shares (or any remaining portion that remains unsubscribed by the existing shareholders) to third parties.

A standard approach to every new funding round is to either obtain waivers from all non-participating shareholders in respect of their pre-emption rights, or otherwise offer the new shares to the existing shareholders first, and then (after the expiry of the period during which existing shareholders may exercise their pre-emption rights) offer the new shares to the new investors.

*Rights of first refusal*

A right of first refusal is offered to existing shareholders in respect of any transfer of shares by a shareholder in the startup to a third party. The right gives the existing shareholders of the startup a right to purchase the shares being sold before a third party can acquire the shares. In a venture capital transaction, a right of first refusal may also be granted to the startup in priority to the existing shareholders.

*Tag along (co-sale) rights*

A tag along (or co-sale) right is typically offered to the holders of Preferred Shares upon the transfer of shares in the startup to a third party. The right gives the investor (as minority shareholder and holder of Preferred Shares) the right to join the sale of shares to a third party. Investors and founders should be very careful when drafting the tag along right, as the key players should seek to limit the tag along right to circumstances where a majority of the startup’s shares are being sold, or otherwise in circumstances when the founders seek to dispose of a significant percentage of their shares. Otherwise, any transfer of shares by a minority shareholder could trigger a flood of accepting (also known as “tagging”) shareholders.

*Drag along rights*

A drag along right is usually offered to a majority of the shareholders (or such number of shareholders that can exercise control over the startup’s management and affairs). It is usually triggered upon the sale of the company, which is typically described as a sale of 50% or more of the company’s assets or shares. The drag along right gives the controlling shareholders the power to force the sale of the minority shareholders’ shares alongside their own. Investors and founders should discuss the appropriate triggers for a drag along right and should ensure that only significant transfers trigger a drag along right.

*Change of control restrictions*

A change of control restriction is a restriction that prohibits any change in the identity of the person (or company) that owns and/or controls an existing shareholder of the startup. This prevents existing shareholders from circumventing applicable rights of first refusal, and ensures that the identity of the person (or company) that controls an existing shareholder does not change, for example, to become a competitor to the startup's business.

**Final considerations**

While once a simple transaction drawn up on a single page setting out indicative terms for the investment, funding round transaction documents have over time grown in length and complexity. A term sheet now can easily exceed 10 pages, with transaction documents much longer.

Legal advice on any funding round is an absolute must; a bad call on a key funding provision could prove to be a costly and destructive mistake for a founder, an investor or even the business in the future. It is therefore essential that entrepreneurs and investors familiarize themselves with industry practices and expectations as to how these arrangements will work.

*Al Tamimi & Company's private equity team regularly advises on venture capital transactions, representing investors, founders and companies on all stages of their funding. For further information please contact Alex Saleh (alex.saleh@tamimi.com), Richard Catling (r.catling@tamimi.com) or Kareem Zureikat (k.zureikat@tamimi.com).*