Know Your Terms: The Key Terms of a Priced Equity VC Transaction

Abdullah Mutawi - Partner, Head of Corporate Commercial - Corporate / Mergers and Acquisitions / Commercial / Private Equity / Digital and Data / Turnaround, Restructuring and Insolvency / Venture Capital and Emerging Companies

- Dubai International Financial Centre

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

k.zureikat@tamimi.com - Dubai International Financial Centre

"The venture capital team at Al Tamimi & Company is evangelical about the correct use of terminology
but also accutely informed of the local specificities and market practices that sometimes result in slightly
different understandings or expectations in deal language and documentation. Managers of in-bound
capital regularly call upon us to give them our view of local market practices and norms."

–*Kareem Zureikat*

The relationship between the founder and the investors is critical to the growth and success of a business and should always be approached with care. Founders will find themselves negotiating against their investors during each funding round, and 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 minimise 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 start-up.

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

In order to "lock-in" the investment, binding subscription agreements are prepared setting out the key terms of the investment. A long form subscription agreement is commonly entered into between the company, the founders and the investors. To the extent the start-up has raised funds through a bridge round using convertible instruments such as a SAFE, KISS or convertible note, the bridge round investors will also sign up to the subscription agreement to document the conversion of their convertible instruments into shares. The subscription agreement includes more comprehensive provisions normally geared towards protecting the 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 start-up. Fundamentally, the shareholders' agreement is the document that reflects: (i) governance, and (ii) economics.

Key terms of the transaction documents

As the party taking the financial risk, each investor will seek preferential economic and voting rights over the rights of existing shareholders (including the start-up 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 start-up 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.

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Liquidation preference and participation

A liquidation preference is a right of the investor to receive proceeds from a “liquidity event” as a 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 start-up’s shares (or a sale of a controlling interest), a sale of a substantial portion of the start-up’s assets or the winding up of the start-up.

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.

Anti-Dilution

A key feature of these start-up 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 economic interest if the value of the start-up 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 to minimise the economic downside of the down round on the investors holding preferred shares.

Protective provisions

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 start-up does not take certain critical decisions without the investor’s approval.

Share transfer provisions

There are several key clauses that grant the shareholders of a start-up (including its investors) certain protections in connection with the transfer of the start-up’s shares or the issue of new shares by the start-up. These are found in the shareholders’ agreement and are usually built into the articles of association of the start-up. These offer investors (and in certain instances only “major investors”), certain rights to purchase, sell or force the sale of the start-up’s shares.

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 being 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 familiarise themselves with industry practices and expectations as to how these arrangements will work.