GLOSSARY

A

Accredited Investor – An individual who meets one or more of the following: $1 million or more in net worth; income in excess of $200,000 in the last two years or a joint income with a spouse exceeding $300,000 in the last two years.

Adjustment Condition – An adjustment condition occurs if the company does not close on an equity investment in the company for a minimum of $xxx, net of brokerage fees, on or before a series of other predetermined events, i.e. delivery of term sheet to preferred stockholders.

Angel Groups – Organizations, funds and networks formed for the specific purpose facilitating angel investments in start-up companies.

Angel Investors – Sophisticated, accredited investors who choose to make early stage investments of time and money in start-up companies.

Anti-dilution Provisions – The means by which one preserves a percentage ownership in the company without having to make a new investment. One does not have to pay in order to maintain their position.

> *Typical* – Provides for protection in the event of a stock split, stock dividend or similar recapitalization.
>
> *Full Ratchet* – Complete preservation of percentage ownership in all circumstances including protection in the event of a subsequent sale or merger.
>
> *Modified Ratchet* – Does not provide for "ratcheting" in limited circumstances such as new subsequent offerings at prices lower than per share investment price ("down rounds") or employee equity offerings.

Automatic Conversion – Under certain circumstances, such as the company going public or a majority of *Series X* share holders voting to convert, all *Series X* shares will be converted 1:1 into common shares.

B

Bridge Financing – Usually in the form of debt convertible into equity issued during the next round of financing.

Brokers – Private individuals or firms retained by early-stage companies to raise funds for a finder's fee.

C

C Corporation – Created by state government, as a routine matter, upon the entrepreneur filing an application and paying a fee. It is a separate entity, with legal existence apart from its owners, the stockholders.

Call - Company's right to force investor to sell his/her shares.

Cap Table – A table describing the capitalization of a company including the names and number of shares owned by each principal and investors. This table is often segmented to describe each of several funding rounds in the company and clearly differentiates preferred and common shareholders.

Clawback - A venture term in which the entrepreneur is allowed to increase his ownership percentage of the company, based on achieving mutually agreed-upon objectives, after the closing of a round in which the entrepreneur was diluted more than anticipated by new investors. Not frequently in use and often replaced by performance-based stock options.

Common Stock – Is the baseline equity of the company. In case of bankruptcy, it is entitled to all assets and cash of the company after the payment of obligations such as bank debt, corporate debt, taxes, trade creditors, employee obligations, and preferred stock. Founders and employees almost always own shares or options for common stock.

Conversion Rights – Rights by which preferred stock "converts" into common stock. Usually, one has this right at any time after making an investment. Company may want rights to force a conversion upon an IPO; upon hitting of certain sales or earnings' targets, or upon a majority or supermajority vote of the preferred stock. Conversion rights may carry with them anti-dilution protections.

Convertible debt - A funding instrument for investments in early stage companies that converts to common or preferred stock at agreed-upon triggers, usually at the option of the investor. Normally earns interest at a moderate rate, payment of which is often deferred. Usually converted to equity securities upon the next subsequent round of investment in the company at a discount to the valuation of that next round of funding. The discount and triggers are negotiated at the time of making the note. This debt instrument put investors ahead of shareholders in case of liquidation and protects investors from down rounds in the next round of investment.
Also may somewhat limit the upside potential for those investors using such notes.

Convertible Preferred Stock – Most common security for venture capital investments. Holders of this class of stock have "preference" over the common shareholders in the event of a liquidation of the company. Preferred shareholders can receive dividends, exercise voting privileges and retain the option to convert to common stock.

Co-Sale Provisions or Rights – Allows investors to sell their shares of stock in the same proportions and for the same terms as the founders, managers, or other investors, should any of those parties receive an offer.

Cram Down – A round of financing at a valuation less than the previous round of investment. In this case, the earlier investors are said to have been "crammed down," that is, to have suffered substantial dilution in ownership percentage at the expense of the current investors. (See also *Down Round*)

Cumulative Voting – Right which gives the minority investor extra voting power by allowing for the spread of votes over many candidates or the concentration of votes to elect one director.

D

Deal Structure - An agreement made between the investor and the company defining the rights and obligations of the parties involved. The process by which one arrives at the final terms and conditions of the investment.

Demand Registration Rights – A negotiated right of investors to convert private ownership in the company through registration as shares eligible for trading in public markets.

Dilution – The reduction in percentage ownership of the company that investors suffer due to subsequent funding rounds.

Dividends – Proceeds paid by the company as a return on an original investment. Generally, they are discretionary with the company and aren't paid unless contracted for or after the company has gone public. Dividends can be paid either in cash or in kind, i.e. additional shares of stock.

> *Cumulative* – Missed dividend payments that continue to accrue.
> *Non-cumulative* – Missed dividend payments that do not accrue.
> *Participating* – Dividends which share (participate) with common stock.
> *Non-participating* – Dividends which do not share with common stock.

Down Round – Price per share is less than in the previous round of financing. (See *Turnaround Financing*)

Due Diligence – Process of validating a potential investment. Usually involves the study of six areas of a company's business plan: market structure, competition and strategy; technology assessment; management team; operating plan; financial review; and legal review. Checking the references of the principals is a critical portion of this process.

E

Equity – Ownership interest in a company, usually in the form of stock or stock options.

Exit Strategy - A planned action taken by a company that results in liquidity of the company's stock, often in the form of an acquisition by a publicly traded company or a public offering.

F

First Close – An early close of part of a round of financing upon the agreement of all parties.

First Refusal Rights –A negotiated obligation of the company or existing investors to offer shares to the company or other existing investors at fair market value or a previously negotiated price, prior to selling shares to new investors.

FMV (fair market value) – An acceptable selling price to an independent third party.

Forced Buyback – Redemption of convertible debt, convertible preferred stock or common stock on pre-specified terms in situations where the company's value has not appreciated according to the agreed upon plan.

Founder Vesting – A term imposed on founders of seed and early stage deals in which the founder ownership is subject to a vesting schedule with nothing up front and linear vesting over, typically, four years. The first twelve months ownership is often "cliff" vested after the first year with monthly vesting thereafter. For more mature companies, vesting credit can be applied at the time of investment. The purpose of this term is to protect investors from an early, unplanned exit by the founder and to provide investors with the equity necessary to attract a new management team.

H

Harvest – Reaping the benefits of investment in a privately held company by selling the company for cash or stock in a publicly held company, also to execute the exit strategy.

I

Information Rights – Rights granting access to company's information, i.e. inspecting the company books and receiving financial statements, budgets and executive summaries.

Intellectual Property – Right or non-physical resource that is presumed to represent an advantage to the firm's position in the marketplace, including patents, trademarks, copyrights and licenses.

Intermediary (Financial Intermediary) – An individual or institution empowered to make investment decisions for other persons or entities.

IPO (initial public offering) – The regulated process by which a private corporation registers its shares for trading in public markets ("going public").

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

L

LLC – Limited liability company – a company owned by "members" who either manage the business themselves or appoint "managers" top run it for them. All members and managers have the benefit of limited liability, and, in most cases, are taxed in the same way as a subchapter S corporation without having to conform to the S Corporation restrictions.

Lead Investor – Leader among the investors in a round of equity investment in a privately held company, usually also the leader of the due diligence efforts related to the same investment round.

Leveraged Buyout – Takeover of a company, using borrowed funds. Most often, the target company assets serve as security for the loans taken out by the acquiring firm, which repays the loan out of the cash flow of the acquired company.

Liquidation Preference – A preference offered to certain investors to over the founders and investors in earlier rounds, upon liquidation of the ownership of the company.

Lock-up Agreement – Agreements entered into between the lead underwriter and significant stockholders, whereby the stockholders agree <u>not</u> to sell any company stock for number of predetermined days (usually 180). This time period allows the market to absorb the company's offerings.

M

Market Standoff Agreement - Similar to Lock-Up Agreements and prevents selling company stock for number of predetermined days after a previous stock offering by the company.

Mezzanine Financing – Provides funds for further business expansion for companies with a year or two of profitability or an initial public offering.

N

Non-Disclosure Agreement (NDA) – An agreement which precludes disclosure to third parties of private information revealed by one party to another, usually for a fixed term.

O

Over-Subscription – Underwriting term describing a new stock issue for which there are more buyers than available shares.

P

Participating Liquidating Preference – Preferred stock, which share (participate) with the common stock upon liquidation or sale. Upon liquidation, those investors with a liquidating preference will receive their original investment, any dividends owed, and perhaps other consideration, <u>before</u> holders of common stock receives a distribution.

Piggyback Registrations Rights –Providing investors and/or company founder(s) the right to sell stock at the IPO (rarely) or a later public offering (more commonly) by adding their shares to the aggregate listed in the registration statement. (See *Registration Rights*)

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.

Pre-emptive Rights – Each holder of at least "x"% of the common equity of the company (on an as-converted to Common Stock basis) shall have the right to provide financing to the company on the same terms offered to third parties in the amount necessary to maintain such holders 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.

Preferred Stock – Most likely security for angel investments. It is senior to common stock and junior to debt. Preferred stock is a contract right, i.e. its terms must be set forth clearly in writing in order to obtain the anticipated rights. It can have a variety of voting, dividend, management, conversion and other rights and must be carefully crafted to ensure the upside and protect against the downside.

Private Placement – The sale of stocks, bonds or other investments directly to institutional or accredited investors. A private placement does not have to be registered with the SEC, as a public offering does, if the securities are purchased for investment as opposed to resale.

Private Placement Memorandum (PPM) – A formal description of an investment opportunity written to comply with various federal securities regulations. A properly prepared PPM is designed to provide specific information to the buyers in order to protect sellers from liabilities related to selling unregistered securities. Typically PPMs contain: a complete description of the security offered for sale, the terms of the sales, and fees; capital structure and historical financial statements; a description of the business; summary biographies of the management team; and the numerous risk factors associated wit the investment. In practice, the PPM is not generally used in angel or venture capital deals, since most sophisticated investors perform thorough due diligence on their own and do not rely on the summary information provided by a typical PPM.

Proof of Concept – Product has been proven to work through analysis of the science.

Put – An investor's right to force company to purchase his/her shares. Used by investors to assure eventual liquidation of their investment. Opposite of a "Call."

R

Ratchet – Ratchets reduce the price at which venture capitalists can convert their debt into preferred stock, which effectively increases their percentage of equity. Often referred to as an "antidilution adjustment."

Redemption – Commencing on a predetermined date after the First Close, at the request of the holders of a predetermined percentage of the then outstanding Series X Preferred, the company will redeem the then outstanding Series X Preferred at a redemption price equal to the purchase price plus any accrued and unpaid dividends (a forced buy-back).

Redemption Rights – Rights to force the company to purchase shares (a "put") and more infrequently the company's right to force investor to sell their shares (a "call"). A Put allows one to liquidate an investment in the event an IPO or public merger becomes unlikely. One may also negotiate a Put effective when the company defaults or fails to make payments upon a key employee's death, etc.

Registration (public offering) – The process by which a company is authorized by the Securities and Exchange Commission (SEC) to offer shares for sale to the public. Generally involved the disclosure of substantial information on the operations and plans of the company.

Registration Rights – Provisions in the investment agreement that allow investors to sell stock via the public market. Means by which one can transfer shares in compliance with the securities laws subject to Lock-Up and Market Stand-off Agreements.

> *Long-form Demand* – Demand registration <u>before</u> the company becomes public. Usually starts one-three years after making an investment and may involve one or two demands for a percentage of stock. Company will use the SEC's long-form – S-1.
>
> *Short-form Demand* – Demand made <u>after</u> the company is publicly traded and is eligible to use SEC's Form S-3.

Piggyback – Company is registering stock either for itself or other stockholders and one can "piggyback" a portion of shares for registration onto the company's registration. Usually have these rights for up to five years after the company becomes public, but cannot exercise them for mergers or employee offerings.

Rights of First Refusal – Right that gives an individual the option of future participation. In private equity, this may be granted to first round investors to participate in future rounds of company financing.

Rule 504 - Company can raise up to $1 million in any 12-month period from any number of investors provided that the company does not advertise the sale. There are restrictions on the resale of the securities, but there is no requirement of disclosure. Investors need not be sophisticated nor is any formal private offering memorandum required. However, offering is subject to the general antifraud provisions of the federal securities laws requiring that all material information be accurately presented to purchasers.

Rule 505 – Company can raise up to $5 million in a 12-month period. Security sales can be made to an unlimited number of accredited investor plus 35 additional investors. Disclosure documents, i.e. a private placement memorandum, must be delivered to all non-accredited investors. If dealing with accredited investors, the number of these is unlimited, but there is no advertising allowed.

Rule 506 – Puts no limit on the amount of money that can be raised, except it must be more than $5 million. No more than 35 non-accredited investors can be involved, and all must be sophisticated. Sellers are restricted from general solicitation and advertising of the sale.

S

S Corporation – Small business corporation in which the owners personally pay the corporation's income taxes.

Screening Deals – The process used to rate or grade the opportunity presented by new ventures, which is followed by a "go..no-go" decision. Deals that pass the screen receive additional attention by the investors. Those that do not pass the screen are rejected.

Scrubbing Deals – The process of doing "due diligence" on new venture opportunities, prior to making an investment decision.

Second-stage Financing – Provides capital for expansion. Companies are typically generating revenue and have a sound management team in place, but may not show bottom-line profits.

Seed Financing – Relatively small amount of financing to an inventor or entrepreneur to prove a concept.

Series A – first round of investment
Series B – second round of investment
Series C – third round of investment

Short-form Demand Registration – (See *Registration Rights*)

Sophisticated Investor – An investor with the education, business background and investment experience to be able to obtain the information needed to make reasonable investment decisions about the company in question.

Start-up Financing – Provided to companies completing product development and for early marketing. Companies may be in the process of organizing or may already be in business, but usually have not sold their product commercially.

Stock Option – Grants the right to purchase securities (usually common stock) at a stated exercise price over some future period of time.

Subordinated Debt – Debt instrument "subordinated" to the lending done by institutions such as banks. This type of debt is viewed as equity and generally does not limit the company's borrowing power.

T

Take Away Provisions – Agreement made between an investor and the management of a company that entitles the investor to penalize the management if the company does not achieve pre-determined results.

Target Multiples – The desired return on investment of private investors in early stage companies, defined in a multiple of the original investment.

Term Sheet – Document that guides lawyers in preparing the investment agreements. Should include at least: agreed-upon valuation of the business including the proposed capitalization table; key financial and legal terms; rights of both parties; and legal obligations of all involved.

Tranche – Funds flowing from investors to a company that represent a partial round or an "early close." Subsequent funds of the single round are generally under the same terms and conditions as the first tranche (or early close), however, those funding the early tranches may receive bonus warrant coverage, in consideration of the additional risk. (a French word meaning a slice or cutting)

Turnaround Financing [or Down Round] - Provided to companies, which still show promise, although they have gone through or are currently in a problem period. Often referred to as "Down Round," since investors supplying the turnaround funds will negotiate a stock price lower than that paid by earlier investors.

V

Venture Capitalist – A financial institution specializing 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. The venture capitalist may provide both funding and varying degrees of managerial and technical expertise.

Vertical Market – A market definition, specialty or niche, such as "enterprise software," "cancer diagnostics" or "fabless silicon design."

Vesting Schedule – Used in stock options to describe the number of shares that the option recipient can purchase at a defined price and at given dates in the future. Also defines the expiration of said options.

Voluntary Conversion – The optional rights of Series A Preferred shareholders to convert shares of Series X Preferred into shares of common stock of the company at the then applicable conversion ratio, which initially may be one-to-one (Initial Conversion Ratio) and subsequently subject to adjustment.

Voting Rights – A shareholders rights to vote for the board of directors and other important events such as sales and mergers. Sometimes divided upon the following lines:

Full – Vote with common stock on each matter as if the preferred shares had been converted into common.

Class – Corporate statute or certificate of incorporation provide a class vote allowing certain 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) – Guaranteed right to elect one or more directors to the board.

Special – Vetoes over certain matters or supershare voting. More common in venture investments.

W

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

1202 Stock – Qualifies for preferential tax treatment of capital gains by further reducing the long-term capital gains tax rate by half (i.e. 10%).

1244 Stock – Provides downside loss relief by allowing the investor to deduct up to $50,000 ($100,000 in the case of a joint tax return) of original losses against ordinary income in any one year.

Sources

The definitions listed in this glossary were obtained from a variety of resources including "Business Angels: A Guide to Private Investing", Robert H. Keeley, Jeffrey M. Cooper, and Gary D. Bloomer, authors, Colorado Capital Alliance, Inc., Publisher; "Plain English Guide to Select Investment Terms" by P. Mitchell Woolery; "The Portable MBA in Entrepreneurship: Second Edition", William D. Bygrave, editor, John Wiley & Sons, Inc.; and the Glossary from the "earlycapital.com" web page.