Terms Used In Venture Financing

Common Stock

Common stock is the basic equity interest in a company. It is typically the type of stock held by founders and employees.

Preferred Stock

Preferred stock has various "preferences" over common stock. These preferences can include liquidation preferences, dividend rights, redemption rights, conversion rights and voting rights, as described in more detail below. Venture capitalists and other investors in private companies typically receive preferred stock for their investment.

"Series" of Preferred Stock

When a company raises venture capital in a preferred stock financing, it typically designates the shares of preferred stock sold in that financing with a letter. The shares sold in the first financing are usually designated "Series A", the second "Series B", the third "Series C" and so forth. Shares of the same series all have the same rights, but shares of different series can have very different rights.

Liquidation Preference

"Liquidation preference" refers to the dollar amount that a holder of a series of preferred stock will receive prior to holders of common stock in the event that the company is sold (or the company is otherwise liquidated and its assets distributed to stockholders). For example, if holders of preferred stock have a liquidation preference equal to $30 million and the company is sold, they will receive the first $30 million before common stockholders receive any amounts. The liquidation preference amount can be paid in cash or stock of an acquirer.

Senior Liquidation Preference

A series of preferred stock has a "senior" liquidation preference when it is entitled to receive its liquidation preference before another series of preferred stock. (All series of preferred stock will, of course, be "senior" to the common stock simply by virtue of having a liquidation preference.) For example, if the Series B has a $30 million senior liquidation preference and the Series A has a $25 million liquidation preference and the company is sold for $40 million, the Series B will receive $30 million and the Series A will receive $10 million.

Multiple Liquidation Preference

The amount of liquidation preference that a given series of preferred stock has is usually equal to the amount paid for the stock. However, in certain financings new investors may require that their liquidation preference amount be equal to more than the amount they originally invested (often referred to as a "multiple" liquidation preference). Multiples tend to be one and one-half to three times the purchase price. A multiple liquidation preference will almost always also be a senior liquidation preference as well. For example, if the Series B was purchased for $30 million, but has a senior liquidation preference equal to two times the purchase price, then the Series B investors will receive the first $60 million on any sale of the company before the Series A or common stockholders receive any amounts.

Participation

Preferred stock is said to "participate" or to have "participation" rights when, after the holders of preferred stock receive their full liquidation preference amount, they are then entitled to share with the holders of common stock in the remaining amount being paid for the company (or otherwise distributed to stockholders).

For example, if the company is sold for $200 million, the preferred stock has a liquidation preference of $30 million and the preferred stock represents 40% of the total number of outstanding shares of the company, then the $200 million would be distributed among stockholders as follows:

(1) First $30 million - Paid to holders of preferred stock per their liquidation preference.
(2) Remaining $170 million:

- Preferred stock holders receive their 40% pro rata share ($68 million) per their participation rights.
- Common stock holders receive remaining 60% ($102 million).

Totals: Preferred stock holders - $98 million
Common stock holders - $102 million

Capped Participation

Participation rights are described as "capped" when the participation rights of the preferred stock are limited so that the preferred stock stops participating in the proceeds of a sale (or other distribution) after it has received back a pre-determined dollar amount (caps typically range from three to five times the original amount invested).

Building on the previous example, if the participation rights of the preferred stock were capped at a 3x multiple of their liquidation preference amount (which 3x includes the amount of liquidation preference), then the result would be that the preferred stock would receive only an additional $60 million in participation in step (2) above. Thus, the total amount received by the holders of preferred stock would be $90 million (down from $98 million without a cap) and the amount received by the holders of common stock would increase to $110 million (up from $102 million).

Note: If the price paid for the company in this example were substantially higher (e.g., $275 million) then the holders of preferred stock would convert to common stock (thereby giving up their liquidation preference) in order to eliminate the 3x cap, because 40% of $275 million equals $110 million, which is $12 million more than the preferred would receive if they did not convert and were subject to the 3x cap.

Cumulative Dividends

Holders of preferred stock having a cumulative dividend right are entitled to be paid, in addition to a liquidation preference, an amount equal to a certain percentage per year of the purchase price for the preferred stock (typically five to eight percent). For example, if the preferred stock purchase price was $20 million, and the stock had a 1x liquidation preference and a six percent cumulative dividend, and if the company was sold after three years, then the preferred stock holders would be entitled to $23.6 million before anything was paid on the common stock. In some circumstances cumulative dividends must be paid annually, but this is unusual in venture financed companies.

Conversion Rate

Almost all preferred stock issued in venture financings can be converted into common stock at the option of the holder of preferred stock. The typical initial conversion rate is one share of preferred stock converts into one share of common stock. However, the conversion rate can change for a number of reasons, such as stock splits or antidilution adjustments.

Antidilution Provisions

Antidilution provisions retroactively reduce the per share purchase price of preferred stock if the company sells stock in the future at a lower prices. This is effected by increasing the conversion rate of the preferred and accordingly increasing the number of shares of common stock into which a share of preferred stock converts.

There are two main types of antidilution protection: weighted average antidilution protection and ratchet antidilution protection.

Weighted Average Antidilution

Weighted average antidilution provisions, which are the milder form of antidilution protection, increase the conversion rate of the preferred stock based on a formula that is intended to take into account the overall economic effect of the sale of new stock by the company. The formula includes variables for the price at which new stock is sold, the price at which the old preferred stock was sold, the total number of new shares issued and the total number of shares outstanding.

Ratchet Antidilution

Ratchet antidilution provisions, which are the tougher form of antidilution protection, increase the conversion rate of the preferred stock based on the price per share at which the company sells its stock in a future down round, regardless of how few or how many new shares are sold at the lower price. This has the effect of retroactively reducing the price per share which the preferred was sold in the current round to the new, lower valuation of a future down round.

Pay to Play

Pay to play provisions impose penalties on investors for not investing their full pro rata share in the next round (typically only if the next round is a down round). The more severe version of these penalties is to provide that investors who do not invest their full pro rata amount will have their existing preferred stock converted into common stock, resulting in the loss of their liquidation preference and antidilution protection, among other rights. A less severe version is to convert the preferred stock into a different series of preferred (often referred to as "shadow preferred") that retains some or all of its liquidation preference, but loses anti-dilution protection, both for the subject financing, and going forward.

Redemption

Redemption provisions allow investors to require the company to repurchase their preferred stock under certain circumstances, typically for the price originally paid. Redemption rights usually cannot be exercised unless the holders of at least a majority (sometimes more) of the preferred stock so request and usually cannot be exercised for four to five years after the financing. In certain circumstances, redemption provisions may provide for a right of exercise more quickly or for a repurchase at more than the original purchase price.

Corporate Reorganization

Corporate reorganizations typically refer to either (a) the conversion of existing preferred stock into common stock, or into a new series of preferred stock with a substantially reduced liquidation preference amount and/or (b) a reverse stock split of outstanding stock. Corporate reorganizations are usually implemented to reset the economic interests of existing stockholders to current economic realities so as to facilitate the company's ability to attract additional investment and to provide appropriate incentive to the management team. The conversion of existing preferred stock into common or a new series of preferred stock has a significant economic effect, as those stockholders will often lose substantial liquidation preferences and other rights. A reverse stock split has no economic effect in and of itself, but is usually undertaken when a company's stock price has fallen significantly and the company wants to raise it to a more typical range.